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Pay your taxes where you add the value

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Pay your taxes where you add the value: how to avoid tax avoidance and abuse?

An overview of measures taken and proposed with a special focus on developing countries

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Chapter 1. Introduction

Insufficient coordination between the different tax systems offers ample opportunities for tax abuse world-wide. Two forms of **abuse of tax law** can be distinguished: **tax evasion** and **tax avoidance**. Whereas tax evasion is illegal, tax avoidance is the reduction of tax within the boundary of the law.

Domestic legislation of both developed and developing countries generally contains both rules to counteract tax evasion and general and specific anti-avoidance legislation, but this is not sufficient to prevent taxpayers from exploiting these differences.

Generally they do so by using one or more of the following **strategies to reduce the tax burden** on international income:

- Avoiding profits taxation in the source country by *avoiding source country jurisdiction*;
- *Transferring the place of residence* for tax purposes to jurisdictions with lower effective tax rates;
- Minimizing profits taxation in the source country through *generating deductible payments* to related parties;
- Shifting profits to subsidiaries in *tax havens or low tax jurisdictions*;
- In case of companies resident in states using the exemption method to prevent double taxation: *establishing a permanent establishment* in a state having lower effective tax rates than the state of residence;
- *Reducing or eliminating withholding tax* in the source country by making use of holding companies or conduit companies to take advantage of a country's tax treaty network
- *Creating double dips* (depreciation and/or tax incentives in two or more countries).

Most countries, including developing countries, adopted **general and/or specific anti-avoidance provisions** in their **domestic legislation**. Besides – depending on the prevailing legal system – **jurisprudential rules** may counter abuse of the domestic tax laws of a State and/or of its tax treaties. Most *tax treaties* also include anti-avoidance provisions generally based on the OECD Model/UN Model Tax Treaty and Commentary. Moreover these treaties contain rules concerning **exchange of information and recovery of tax claims**. Similar provisions can be found in the OECD/Council of Europe Convention on Mutual Administrative Assistance in Tax Matters and for EU Member States in EU-Directive 2011/16.

These provisions however by far are not sufficient to deal with all forms of tax avoidance and evasion. As the forms of abuse in international relations depend on the specific features of the tax legislation of the countries involved the *Commentaries to the OECD Model and the UN Model* provide some comments that are intended to prevent tax avoidance e.g. in respect of the twelve months period for a building or construction PE, mentioning that apart from domestic anti-avoidance legislation countries concerned with this issue can adopt solutions in the framework of bilateral negotiations; and in respect of an increase of the number of shares shortly before the dividend-payment primarily for the purpose of securing the benefits of the treaty-provision.



Since 2003 the Commentary to art. 1 OECD Model (par. 9.5) explicitly contains the **guiding principle** that the benefits of double taxation convention should not be available:

*“where a **main purpose** for entering into certain transactions or arrangements was to secure a more favourable tax position and obtaining that more favourable treatment in these circumstances would be contrary to the object and purpose of the relevant provisions”.*

However the Commentary warns: “It is important to note, that it should not be lightly assumed that a taxpayer is entering into the type of abusive transactions referred to above”. And it contains several examples of tax treaty provisions that may be used to counteract tax abuse as well as of specific tax treaty provisions that may be included in bilateral tax treaties to counteract abuse that would fit in the specific case.

The UN Model 2001 and the UN Model 2011 generally provide for the same or similar types of anti-avoidance provisions and remarks in the Commentary concerning tax abuse as the OECD Model provides for. The UN endorsed the OECD guiding principle referred to above (par. 24 of the Commentary to Art. 1 UN Model) and underlines that for tax treaties to achieve their role:

“it is important to maintain a balance between the need for tax administrations to protect their tax revenues from the misuse of tax treaty provisions and the need to provide legal certainty and to protect the legitimate expectations of taxpayers”¹.

Thus the domestic and international rules to prevent tax avoidance and tax evasion show the characteristics of a **global ‘patchwork’** leaving ample opportunities for companies to make use of mismatches and loopholes.

The G20 and OECD try to address mismatches and loopholes through the **BEPS (Base Erosion and Profit Shifting) project** started in 2013. The first results of this project were published in 2014. The OECD intends to publish its full set of recommendations by the end of 2015. Other international organizations, such as **EU, UN, IMF and World Bank**, as well as **regional organisations and individual countries** are active with own initiatives, either to enhance fiscal co-operation between states (both developed and developing) or to strengthen capacities of tax administrations of developing countries. In October 2013, the **United Nations Committee of Experts on International Cooperation in Tax Matters** established a **Subcommittee on base erosion and profit shifting issues for developing countries**. The Subcommittee is mandated to:

“draw upon its own experience and engage with other relevant bodies, particularly the OECD, with a view to monitoring developments on base erosion and profit shifting issues and communicating on such issues with officials in developing countries (especially the less developed) directly and through regional and inter-regional organisations. This communication will be done with a view to inform developing countries on such issues; facilitate the input of developing country experiences and views into the on-going UN work, as appropriate; and facilitate the input of developing country experiences and views into the OECD/G20 Action Plan on Base Erosion and Profit Shifting (BEPS)”².

¹ Par. 9 Commentary to art. 1 UN Model 2011.

² http://www.un.org/esa/ffd/tax/BEPS_note.pdf.

This background paper shows:

- why the OECD refers to a global 'patchwork' of domestic and anti-avoidance rules;
- which measures the OECD in its BEPS Project recommends to address the mismatches and loopholes; and
- to what extent the special needs of developing countries are recognized.

Moreover we will also make some suggestions not included in the BEPS Reports on how developing countries might tackle tax abuse.

Chapter 2 provides for definitions of the terms tax evasion, tax avoidance, (aggressive) tax planning and treaty shopping.

Chapter 3 contains an overview of the main types of domestic anti-avoidance measures used in both developed and developing countries, as well as of the suggestions for anti-avoidance rules in the Commentary to Art. 1 OECD Model and the Commentary to Art. 1 UN Model, and some specific anti-avoidance rules included in bilateral tax treaties.

Chapter 4 contains an overview of the measures proposed in the BEPS Action Plan.

Chapter 5 provides some background information on the work of the G20 Development Working Group (DWG) mentioned in the *OECD Report to G20 Development Working Group on the impact of BEPS in low income countries* as being of specific importance for developing countries.

Chapter 6 provides for a short summary of the Actions 4, 6, 7, 10, 11 and 13 that have been identified by the DWG as being of specific importance for developing countries.

In Chapter 7, 8, 9 and 10 we give some more in-depth background information and suggestions on:

a. the following BEPS measures that have been identified by the DWG as very relevant for developing countries, to wit:

- **Chapter 7.1: Measures to counteract erosion of the tax base through payments of interest on loans** (addressed by BEPS Action 4);
- **Chapter 7.2: Transfer Pricing** (addressed by BEPS Action 8, 9, 10 and 13);
- **Chapter 8: Treaty abuse** (addressed by BEPS Action 6).

b. **Tax incentives** and **Exchange of information** are not part of the BEPS Action Plan, but according to DWG highly relevant for developing countries. Tax incentives (*Chapter 9*) may without being effective erode the tax base. Tax authorities in assessing and auditing domestic companies that operate in foreign countries and foreign companies that operate in their country need access to information that is relevant for assessment and auditing. Exchange of information is essential (*Chapter 10*).

Chapter 2. Terminology

Tax evasion occurs when a tax liability is hidden or ignored because the potential taxpayer has not complied with legal rules either by not paying or when the facts or events leading to tax liability cannot be established by the tax authorities due to e.g. fake expenses, criminal activities or taxpayers hiding income or information from tax authorities.

Tax evasion may be intentional or unintentional. Generally, if it involves wilful or **intentional** fraud or deceit, evasion would be a criminal offence. **Unintentional** evasion is usually subject only to payment of tax due, increased by interest and a penalty, e.g. if, contrary to legal requirements, an incomplete or incorrect tax return has been filed, intentionally or unintentionally.

Tax avoidance is a term that is difficult to define but which is generally used to describe the arrangement of a taxpayer's affairs that is intended to reduce his tax liability and that although the arrangement could be strictly legal it is usually in contradiction with the intent of the law it purports to follow.

The distinction with **tax planning** or **tax mitigation** is not easy, since planning equally involves the reduction of a person's tax liability. However, tax planning is done in ways that are deemed consistent with the rationale of the tax legislation. Tax avoidance is deemed to be contrary to intention or spirit of the law. The OECD and the UN refer to **aggressive tax planning** as taking advantage of the technicalities of a tax.

A term also closely connected to tax avoidance is **treaty shopping**. This is a form of tax avoidance in which a person not resident of either of the treaty countries establishes an entity in one of the treaty countries in order to obtain treaty benefits, e.g. reduction or elimination of withholding tax.

Typical examples of such entities are:

a. Base companies

Companies situated in a low tax country or no tax country, or a country which has a favourable tax treatment for certain items of income, is used to shelter income and reduce taxes in the taxpayer's home country. Generally it carries on certain activities on behalf of related companies in high tax countries, e.g. management services, or is used to channel certain income such as dividends, interest, royalties and fees. The term also includes captive insurance companies.

b. Conduit companies

A company set up generally in a country with a beneficial/extensive tax treaty network and low tax rates, whereby income is paid by a company to the conduit and then redistributed by that company to its shareholders as dividends, interest, royalties, etc.

Such companies are referred to as letter-box companies or shell companies if such companies comply only with the basic essentials for organizations.

Chapter 3. Anti-abuse measures in domestic law and treaty law

1. Domestic law

Many countries included general and/or specific anti-avoidance rules in their domestic tax law. General rules may have the form of a **General Anti-Abuse Rule (GAAR)** describing which types of arrangements are considered as abusive and which method should be used to counteract it, or of e.g. a **substance-over-form rule** or **economic substance rule** only describing the nature of the arrangement.

Specific rules take numerous forms, such as **CFC-legislation, thin capitalization-rules, exit taxes, beneficial ownership-rules, anti-avoidance rules concerning interest deduction, participation exemption, group treatment and facilities for mergers.**

Moreover depending on the applicable legal system judges may also develop **judiciary doctrines** preventing tax abuse.

2. Tax treaties

As mentioned above anti-avoidance measures in tax treaties are still limited, to wit:

- a. a beneficial ownership-requirement in the dividend-, interest- and royalty-articles (Art. 10.2, 11.2 and 12.1 OECD/UN Model);
- b. provisions to assure that the reduced tax rates provided in the interest and royalty-articles only apply to the amount of arm's length interest and royalty's³ (art. 11.6 OECD/UN Model and art. 12.4 OECD Model resp. 12.6 UN Model);
- c. a provision preventing tax treaty abuse by making use of an indirect transfer of immovable property through the alienation of shares of the capital of stock of an immovable property company. To this the UN-treaty adds "an interest in a partnership, trust or estate the property of which consists directly or indirectly principally of immovable property situated in a Contracting State" (art. 13.4 OECD/UN);
- d. a provision dealing with income derived by entertainers and sportspersons from their personal activities (art. 17.2 OECD/UN Model); and
- e. art. 5.7 UN Model stating that an agent (broker, general commission agent or any other agent of an independent status) will not be considered as independent within the meaning of this paragraph when the activities of such an agent are devoted wholly or almost wholly on behalf of the principal and conditions are made or imposed between that enterprise and the agent in their commercial and financial relations which differ from those which would have been made between independent enterprises.

Main reason for this lack of anti-abuse rules in tax treaties is that the aim of tax treaties until the nineties of the previous century was preventing double taxation. In 1992 the OECD added to its Commentary that it is also a purpose of tax conventions to prevent tax avoidance and evasion and that it is agreed that States do not have to grant the benefits of a double taxation convention where arrangements that constitute an abuse of the provisions of the convention have been entered into. The UN does not mention preventing abuse in its Commentary. This Commentary mentions that the general objectives of bilateral tax treaties are: to protect taxpayers against double taxation with a view to improving the flow of international trade and investment and the transfer of technology; to

³ The excess above the amount which would have been agreed upon by the payer and the beneficial owner in the absence of a special relation shall remain taxable according to the law of each Contracting State.

prevent certain types of discrimination as between foreign investors and local taxpayers; and to provide a reasonable element of legal and fiscal certainty as a framework within which international operations can confidently be carried on. Nevertheless the UN:

- acknowledges that “improper uses of tax treaties are a source of concern to all countries but particularly for countries that have *limited experience* in dealing with sophisticated tax-avoidance strategies”⁴;
- devotes par. 10 – 57 of the Commentary to Art. 1 to a *description of approaches* to prevent improper use of tax treaties;
- remarks that tax treaties seek to improve cooperation between taxing authorities in carrying out their functions, including by the *exchange of information* with a view to preventing avoidance or evasion of taxes and by *assistance in the collection of taxes*.

Bilateral tax treaties often contain the anti-avoidance measures referred to above. Several tax treaties also include some of the anti-avoidance measures suggested in the Commentary to the OECD Model:

- **subject-to-tax provisions** granting treaty benefits only if or depending on whether or not the income in question is subject to tax/to a reasonable amount of tax;
- **exclusion provisions** disallowing countries to grant tax privileges in case of conduit arrangements;
- **limitation on benefits provisions** dealing in particular with treaty shopping and disallowing treaty benefits to certain persons who would without such provision qualify as resident for tax treaty purposes.

Besides the general or specific domestic rules and the tax treaty rules mentioned above, tax authorities may counteract abuse through:

- a. **resident articles** in domestic law and tax treaties. Tax authorities may state that the effective place of management of a subsidiary is in fact in the state of the parent company. It may not be easy to provide sufficient evidence;
- b. **permanent establishment articles**. Tax authorities may state that the taxpayer has a permanent establishment or a permanent representative in their country to which part of the profits should be allocated;
- c. **transfer pricing rules**. Tax authorities may state that the taxpayer’s transactions and/or prices used are not arm’s length.⁵

⁴ Par. 8 Commentary to Art. 1 UN Model Tax Convention.

⁵ Chapter 8 of this background paper contains an overview of existing anti-avoidance measures in domestic law and tax treaties.

Chapter 4. Base Erosion and Profit Shifting Action Plan

The global 'patchwork' of anti-avoidance measures in domestic law and tax treaties leaves ample opportunities for taxpayers to make use of mismatches and loopholes. In order to get a better picture of the problem at the request of the G20 Finance Ministers the OECD investigated practices of multinational companies through which they pay only 5% corporate income tax whereas smaller companies pay up to 30%⁶. Multinationals create numerous offshore subsidiaries or shell companies in order to make use of tax facilities and claim expenses in high countries whereas they shift risks (such as insurance risks and risks connected with financial activities) and connected profits to low tax countries. A first result was published in the 2012 Hybrid Mismatch Report. A hybrid mismatch arrangement is a profit shifting arrangement exploiting differences in the tax treatment of instruments, entities or transfers between two or more countries by utilising a hybrid element in the tax treatment of an entity or instrument to produce a mismatch in tax outcomes in respect of a payment that is made under that arrangement: hybrid entities, hybrid instruments, hybrid transfers and dual resident companies may result in double deduction, deduction/no inclusion or foreign tax credit generators. The report mentions as policy options harmonisation of domestic laws, general anti-avoidance rules, specific anti-avoidance rules and rules specifically addressing hybrid mismatch arrangements.

On 19 July 2013 the OECD published the BEPS Action Plan stating that international standards must be designed to ensure the coherence of corporate income taxation at the international level.

The 15 Actions identified in this Report to address BEPS are based on the following core principles: coherence, substance, transparency, certainty and predictability.

No particular action to prevent tax avoidance or abuse in the context of the digital economy is mentioned in the Report on Action 1 the Digital Economy, published in September 2014. In the report it is mentioned that the project will examine four issues, i.e. ensuring that core activities cannot inappropriately benefit from the exception to PE status and artificial arrangement relating to sales of goods and services cannot be used to avoid PE status; the importance of intangibles, the use of data, and the spread of global value chains and their impact on transfer pricing; the possible need to adapt CFC rules to the digital economy; and addressing opportunities for tax planning by businesses engaged in VAT exempt activities by encouraging implementation of the OECD'S Guidelines on the place of taxation for B2B supplies of services and intangibles⁷.

The options to address these issues have been left pending the completion of other BEPS Actions, particular waiting for the work of the Task Force on Action 7 (preventing the artificial avoidance of PE status). The work of this Task Force extends to consider whether activities that may have been preparatory or auxiliary should be denied the benefits of the exceptions under article 5(4) OECD Model⁸. Moreover the report noted that attention should be paid to the consequences of greater integration in MNEs and should evaluate the need for increased reliance on value chain analyses and profit split as a method to determine transfer prices (Action 10).

The table in Annex 1 provides for an overview of the Actions and a Timetable showing the dates on which Reports were delivered and on which Reports are expected (status 11-06-2015).

⁶ <http://oecdinsights.org/2013/02/13/beps-why-youre-taxed-more-than-a-multinational/>.

⁷ OECD (2014), *Addressing the Tax Challenges of the Digital Economy*, p. 158.

⁸ OECD (2014), *Addressing the Tax Challenges of the Digital Economy*, p. 159.

Chapter 5. The OECD Report to G20 Development Working Group on the impact of BEPS in low income countries

5.1. Issues may manifest differently

The 19 July 2013 BEPS Report includes a methodology part in which it is stated that:

- developing countries also face issues related to BEPS, though the **issues may manifest differently** given the specificities of their legal and administrative framework;
- the **UN participates in the tax work of the OECD** and will certainly provide useful insights regarding the particular concerns of developing countries;
- the **Task Force on Tax and Development (TFID)** and the **OECD Global Relations Programme** will provide a useful platform to discuss the specific BEPS concerns in the case of developing countries and explore possible solutions with all stakeholders;
- **existing mechanisms** such as the Global Fora on Tax Treaties, on Transfer Pricing, on VAT and on Transparency and Exchange of Information for Tax Purposes will all be used to involve all countries in the discussions regarding possible technical solutions.

The G20 Development Working Group (DWG) – established in 2010 - asked the OECD to draw together the experiences of developing countries and international organisations in a report on the main sources of BEPS in developing countries and how these relate to the OECD/G20 BEPS Action Plan on this issue. Part 1 and 2 of a “*Report to G20 Development Working Group on the Impact of BEPS in Low Income Countries*” were published on the website of the OECD in July/August 2014. Moreover the Global Forum on Transparency and Exchange of Information for Tax Purposes published its Final Report “*Automatic Exchange of Information: A Roadmap for Developing Country Participation*” on 5 August 2014.

5.2 Issues and Action Points most relevant for developing countries by DWG

The dialogue and consultation with developing countries and the experiences of international organisations working with developing countries showed that developing countries and international organisations identify the following **key BEPS issues as being of most relevance**:

- 1) Base erosion caused by **excessive payments** to foreign affiliated companies in respect of interest, service charges, management and technical fees and royalties;
- 2) Profit shifting through **supply chain restructuring** that contractually reallocates risks, and associated profit, to affiliated companies in low tax jurisdictions;
- 3) Significant difficulties in **obtaining information** needed to assess and address BEPS issues, and to apply their transfer pricing rules;
- 4) The use of techniques to **obtain treaty benefits** in situations where such benefits were not intended;
- 5) Tax loss caused by the techniques used to avoid tax paid when **assets** situated in developing countries are **sold**.

DWG considers as the **most important BEPS Action Points for developing countries**:

Action 4 - Limit base erosion via interest deductions and other financial payments;
Action 6 - Prevent treaty abuse;
Action 7 - Prevent the artificial avoidance of PE status;
Action 10 - Assure that transfer pricing outcomes are in line with value creation – other high-risk transactions;
Action 11 - Establish methodologies to collect and analyse data on BEPS and the actions to address it;
Action 13 - Re-examine transfer pricing documentation.

Of medium importance are:

Action 1 - Address the tax challenges of the digital economy;
Action 5 - Counter harmful tax practices more effectively;
Action 8 - Assure that transfer pricing outcomes are in line with value creation – intangibles;
Action 9 - Assure that transfer pricing outcomes are in line with value creation – risks and capital;
Action 12 - require taxpayers to disclose their aggressive tax planning arrangements;
Action 14 - Make dispute resolution mechanisms more effective.

The following Actions are considered to be of low importance for developing countries:

Action 2 - Neutralise the effects of hybrid mismatch arrangements;
Action 3 - Strengthen controlled foreign company rules;
Action 15 - Develop a multilateral instrument.

5.3 Other issues considered relevant by DWG: Tax Incentives and Capacity development

DWG points out that besides the BEPS actions referred to by the OECD **wasteful tax incentives** - which may erode the country's tax base with little demonstrable benefit - are a matter of concern for developing countries.⁹

In section 5 of Part 2 of the Report DWG addresses **capacity development issues**. Reference is made to the initiatives of the OECD, WBG and EU, started in 2011, to support developing countries to strengthen their transfer pricing rules and their implementation. Support initiatives at the time the Report was published (August 2014) were in place in Colombia, Ethiopia, Ghana, Kenya, Peru, Rwanda, Vietnam and Zambia. G20 countries on an individual basis also offer assistance to low income countries. Moreover business and civil society provide assistance in capacity building. In Africa acting regionally through the ATAF increases co-operation, e.g. through the development of the ATAF Agreement on Mutual Assistance in Tax Matters (AMATM).¹⁰

Risk and need tests may help to set priorities. Furthermore DWG points out that much of the training they have received over a number of years has focused on theory and principles. **There is high demand for a focus on the practical implementation of rules, skills building and peer-learning,**

⁹ Chapter 9 (Tax Incentives) of this background paper further discusses this issue.

¹⁰ Mutual Assistance in the form of exchange of information is discussed in more detail in Chapter 10 (Exchange of Information) of this background paper.



centred on practical case studies and issues encountered by the tax administrations. **The OECD's Tax Inspectors Without Borders initiative** may assist with improving the quality and consistency of tax audits. Moreover DWG points out that competitive terms and conditions of employment are needed in tax administrations.

5.4 Remarkable: low priority of Actions 2 and 5

It is submitted it is **remarkable** that developing countries feel hybrid mismatches and the development of a multilateral instrument - which enables jurisdictions that wish to do so to implement measures developed in the course of the work on BEPS and amend bilateral tax treaties - of low importance.

As we show in Chapter 7.1 hybrid mismatches may be used for base erosion through interest and other payments (Action 4) and easy structures may be used.

One of the multilateral's instrument's most attractive features is that it enables countries, having diverse interests, but a common objective, to conclude without the need of time-consuming renegotiations of existing tax treaties, international anti-abuse provisions at relatively low cost. For this reason **despite the low priority DWG explicitly calls on G20 countries to engage in dialogue** with developing countries on the design and potential benefits of the **Multilateral instrument**.

Chapter 6. Summary of recommendations in BEPS Consultation Documents/Reports/Discussion Drafts on Actions considered as most important for developing countries

Below a summary of the recommendations of the Actions developing countries consider as most important is provided.

6.1 Action 4 Limit base erosion via interest deductions and other financial payments

a. Report 18 December 2014

On 18 December 2014 the OECD published a Consultation Document asking the public for input on a number of questions concerning base erosion via interest deductions and other financial payments. The OECD acknowledges that:

- the existence of base erosion and profit shifting has been established through a number of *academic studies*;
- the objective of the work on Action 4 is to identify *coherent and consistent solutions* to address base erosion and profit shifting using interest or financial payments economically equivalent to interest;
- rules which encourage groups to adopt funding structures which more closely align the interest expense of individual entities with that of the overall group may *best achieve this aim*;
- **the rules should:**
 - o **minimise distortions to the competitiveness of groups, minimise distortions to investment in a country, avoid double taxation, minimize administrative costs to countries and compliance costs to groups, promote economic stability, provide certainty of outcome; should be robust against attempts by groups to avoid the impact of the rule;**
 - o **should be – in order to achieve a consistent international approach - in accordance with EU treaty freedoms, directives and State Aid regulations.**

Six groups of rules currently applied by countries **to tackle BEPS using interest expense** were identified, to wit:

- | |
|---|
| <ol style="list-style-type: none">1. Rules which limit the level of interest expense or debt in an entity with reference to a fixed ratio;2. Rules which compare the level of debt in an entity by reference to the group's overall position;3. Targeted anti-avoidance rules which disallow interest expense on specific transactions;4. Arm's length tests, which compare the level of interest or debt in an entity with the position that would have existed had the entity been dealing entirely with third parties;5. Withholding tax on interest payments, which are used to allocate taxing rights to a source jurisdiction;6. Rules which disallow a percentage of the interest expense of an entity, irrespective of the nature of the payment or who it is made to. |
|---|

Pros and cons of these rules are described, such as **flexibility, easy for tax administrators, complex system, and possibilities for manipulation.**

There is a general view that:

- in many cases international groups are **still able to claim interest deductions** significantly in excess of the group's actual third party interest expense; and
- existing **rules are complex** and are **not fully addressing** the underlying issues.¹¹

As an approach based entirely on targeted rules may result in a large number of rules which will increase complexity as well as compliance and administrative costs, the **OECD Working Party prefers a combined approach combining a general rule** (e.g. earnings stripping rule, limiting the amount of related-party interest deductions) **with targeted rules to address specific abuse risks.**

b. Reference in Report on Action 4 to specific needs of developing countries?

The OECD refers to a number of Academic Studies concerning the issue in its 18 December 2014 Report, amongst others to a study of Fuest indicating that developing countries are even more prone to debt shifting than developed countries¹². One of the recommendations is to set a **benchmark rate for interest**. The Working Party acknowledges that in determining the benchmark ratios provided for in countries' laws it should be taken into account that interest rates vary between countries and currencies. Therefore, groups with debt in certain currencies, and in particular those operating in developing countries, may be subject to higher interest rates. These differences should be taken into account in setting a benchmark ratio appropriate to a country's economic environment (par. 161 of the Consultation Document).

c. DWG's recommendations on Action 4

DWG calls on the OECD, IMF, UN, WBG and regional organisations, where appropriate and they are in the position to do so, to assess how practical toolkits can be produced to assist developing countries to implement rules to address BEPS issues relating to base eroding payments between MNE affiliates, consisting of e.g.:

- "an explanatory note describing how risks from base eroding payments between MNE affiliates arise;¹³
- a paper on policy considerations and implications related to measures to counter tax loss arising from such payments;
- a description and analysis of regulatory options available, such as transfer pricing, thin capitalisation, anti-avoidance rules, BEPS special measures, as well as treaty measures, outlining potential advantages and disadvantages of each, in the light of country experiences to date;
- model legislation and explanatory notes;

¹¹ Chapter 7.1 (Financial Instruments) of this background paper provides an overview how companies generally exploit the difference in taxation of debt and equity, provides for examples and of policies countries may use to tackle this base erosion.

¹² Fuest et al., 'International debt shifting and multinational firms in developing economies' (2011) 113 Economic Letters 135, 137.

¹³ A general description on this issue can be found in Chapter 7.1 (Financial Instruments) and 7.2 (Transfer Pricing) of this background paper.

- guidance on the administration of regulatory options (including governance), and practical auditing techniques;
- supporting training materials”.

6.2 Action 6 Prevent treaty abuse¹⁴

a. Report 16 September 2014

As a general rule states should adopt a “minimum level of protection” to prevent treaty abuse. In the title and preamble of their treaties they should include a clear statement that the Contracting States, when entering into a treaty, intend to avoid creating opportunities for non-taxation or reduced taxation through tax evasion or avoidance, including through treaty shopping arrangements. Instead of what might have been expected considering the fact that the OECD referred to a global ‘patchwork’ of rules preventing tax avoidance and tax evasion, the OECD does not propose a one-size fits all solution. The OECD recommends:

- a **Limitation On Benefits (LOB) rule** to address a large number of treaty shopping situations based on the legal nature, ownership in, and general activities of, residents of a Contracting State;
- b. to add a more general anti-abuse rule based on the principal purposes of transactions or arrangements (**the Principal Purposes (PPT)-Test**) to address other forms of treaty abuse, including treaty shopping situations that would not be covered by the LOB-rule, such as conduit financing arrangements.

The LOB-rule offers greater **certainty**, the PPT-rule administrative **simplicity**.

Countries should implement the common intention to eliminate double taxation without creating opportunities for non-taxation or reduced taxation through tax evasion or avoidance through either the combined approach of LOB-rule and PPT-rule, the inclusion of the PPT rule or the LOB rule supplemented by a mechanism that would deal with conduit arrangements not already dealt with in tax treaties, such as a restricted PPT rule applicable to conduit financing arrangements or domestic anti-abuse rules or judicial doctrines that would achieve a similar result.

The PPT is intended **to supplement** the LOB provision in such a way that a benefit that would be denied under the LOB provision would not then be subject to analysis under the PPT, whereas a benefit that would be allowed under the LOB provision would not be granted if the PPT is not satisfied.

The Report provides examples of both PPT- and LOB-rule, with for LOB options for a derivative benefit test and a test concerning the availability of treaty benefits to collective investment vehicles and other funds¹⁵. It is recognized that countries do not have to follow the exact wording of these suggestions.

¹⁴ Chapter 8 of this background paper contains an overview of existing anti-avoidance measures in domestic law and tax treaties.

¹⁵ A derivate benefit test allows treaty benefits to companies in certain situations where the treaty benefit with respect to an item of income of the company is comparable to the treaty benefit that would have been available to the shareholders of the company had they received that item of income.

Flexibility is required as:

- a. some countries may have **constitutional or EU law restrictions** that prevent them from adopting the exact wording of the model provisions that are recommended in the Report;
- b. some countries may have **domestic anti-abuse rules that effectively prevent some of the treaty abuses described in this report** and, to the extent that these rules conform with the principles set out in this report and offer the minimum protection referred to in par. 14 of the Report may not need some of the rules proposed in the Report;
- c. **the courts of some countries have developed various interpretative tools (e.g. economic substance, substance-over-form) that effectively address various forms of domestic law and treaty abuses and these countries might not require the general treaty abuse provision** included in the Report¹⁶ or **might prefer a more restricted form** of that provision;
- d. the **administrative capacity** of some countries might prevent them from applying certain detailed treaty rules and might require them to opt for more general anti-abuse provisions.

The OECD recognizes **the adoption of anti-abuse rules in tax treaties is not sufficient to address tax avoidance strategies that seek to circumvent provisions of domestic tax laws** and provides for the following examples:

- a. Thin capitalisation and other financing transactions that use tax deductions to lower borrowing costs;
- b. Dual residence strategies (e.g. a company is resident for domestic tax purposes but non-resident for treaty purposes);
- c. Transfer mispricing;
- d. Arbitrage transactions that take advantage of mismatches found in the domestic law of one State and that are:
 - o related to the characterization of income (e.g. by transforming business profits into capital gain) or payments (e.g. by transforming dividends into interest);
 - o related to the treatment of taxpayers (e.g. by transferring income to tax-exempt entities or entities that have accumulated tax losses; by transferring income from non-residents to residents);
 - o related to timing differences (e.g. by delaying taxation or advancing deductions).
- e. Arbitrage transactions that take advantage of mismatches between the domestic laws of two States and that are:
 - o related to the characterization of income;
 - o related to the characterization of entities;
 - o related to timing differences.
- f. Transactions that abuse relief of double taxation mechanisms (by producing income that is not taxable in the State of source but must be exempted by the State of residence or by abusing foreign tax credit mechanisms).

The Report mentions that **these strategies must be addressed through domestic anti-abuse rules**, including through rules that may result from the work on other aspects of the Action Plan. Work aimed at preventing the granting of treaty benefits with respect to these strategies seeks to ensure that treaties do not inadvertently prevent the application of such domestic anti-abuse rules:

¹⁶ Subsection A.1(a)(ii).

“granting the benefits of treaty provisions in such cases would be inappropriate to the extent that the result would be the avoidance of domestic tax”¹⁷.

The OECD explains in par. 9.2 of the Commentary to Art. 1 OECD Model that **as a general rule, there will be no conflict between domestic anti-abuse rules and tax treaty provisions**: “to the extent anti-avoidance provisions are part of the basic domestic rules set by domestic tax laws for determining which facts give rise to a tax liability, they are not addressed in tax treaties and are therefore not affected by them”. The OECD furthermore explains that some states view some abuses as being abuses of the convention itself as opposed to abuses of domestic law and that the object and purpose of tax conventions as well as the obligation to interpret them in good faith (Article 31 of the Vienna Convention on the Law of Treaties) allows them to disregard abusive transactions. The above shows the differences in legal culture largely determine the state’s view on anti-abuse rules. The differences in legal culture are reflected in the different types of anti-avoidance legislation and jurisprudential doctrines. The Report of 16 September 2014 recommends the inclusion of additional guidance in the Commentary to the OECD Model Tax Convention in order to clarify that **the incorporation of that principle into tax treaties will not affect the existing conclusions concerning the interaction between treaties and domestic anti-abuse rules**.

The Report also recommends that the principle that treaties do not restrict a State’s right to tax its own residents (subject to certain exceptions) should be expressly recognized through the addition of a new treaty provision based on the so-called “**saving clause**”. An example is the provision included in the Protocol of the treaty between the United States and Chili:

“Notwithstanding any provision of the Convention, a Contracting State may tax its residents (as determined under Article 4 (Residence)), and by reason of citizenship may tax its citizens, as if the Convention had not come into effect”.

Moreover the Report recommends a clarification in the Commentary to the OECD Model that treaties do not prevent the application of “**departure**” or “**exit**” **taxes**, under which liability to tax on some types of income that has accrued for the benefit of a resident (whether an individual or a legal person) is triggered in the event that the resident ceases to be a resident of that State.

An example is art. 13(6) and 13(7) of the treaty between the Netherlands and Ghana that provides:

“6. Notwithstanding the provisions of paragraph 5, the Netherlands may, in accordance with its own laws, including the interpretation of the term “alienation”, levy tax on gains derived by an individual who is a resident of Ghana from the alienation of shares in, “jouissance” rights or debt-claims on a company whose capital is divided into shares and which, under the laws of the Netherlands, is a resident of the Netherlands, and from the alienation of part of the rights attached to the said shares, “jouissance” rights or debt-claims, if that individual - either alone or with his or her spouse - or one of their relations by blood or marriage in the direct line directly or indirectly holds at least 5 per cent of the issued capital of a particular class of shares in that company. This provision shall apply only if the individual who derives the gains has been a resident of the Netherlands in the course of the last ten years preceding the year in which the gains are derived and provided that, at the time he became a resident of Ghana, the above-mentioned conditions regarding share ownership in the said company were satisfied.

In cases where, under the domestic laws of the Netherlands, an assessment has been issued to the individual in respect of the alienation of the aforesaid shares deemed to have taken place at the time of his emigration from the Netherlands, the above shall apply only insofar as part of the assessment is still outstanding.

7. Notwithstanding the provisions of paragraph 5, gains from the alienation of any property within the meaning of paragraph 5 situated in Ghana derived by an individual who has been a resident of Ghana and who has become a resident of the Netherlands, may be taxed in

¹⁷ See p. 13 of the Report.



Ghana if the alienation of the property occurs within any period of five years next following the date on which the individual ceased to be a resident of Ghana”.

Finally the Report provides guidance in respect of **specific forms of abuse**: splitting-up of contracts, hiring-out of labor, transactions intended to avoid dividend characterization, dividend transfer transactions, transactions that circumvent the application of Article 13(4) OECD Model (anti-abuse provision regarding immovable property companies), transfer of shares, debt-claims, rights of property to PEs solely set up for that purpose in countries that offer preferential treatment to the income from such assets.

b. Revised Discussion Draft 22 May 2015

Paragraph 5 of the Report of 16 September 2014 indicated that follow-up work would be done on certain aspects of the Report. Twenty different issues were identified in the 21 November 2014 Discussion Draft. The Revised Discussion Draft contains the follow-up.

The LOB-rule presented in the September 2014 Report is six and half pages long, and complex. In its Discussion Draft of 22 May 2015 the OECD presents an **alternative simplified two-and-half pages long LOB rule** which is intended to be used in combination with the PPT rule, as well as new proposals for treaty rules intended to address concerns related to special tax regimes¹⁸ and to changes to domestic law made after the conclusion of a treaty.

In respect of the comment of most commentators that it is essential that the application of the PPT rule be subject to **MAP arbitration** the OECD Working Party decided that the issue should also be discussed as part of the work on Action 14. Moreover the Working Party decided to add four new examples on the functioning of the PPT rule to the five examples provided in the draft for a Commentary on the PPT rule in the 16 September 2014 Report.

c. Reference concerning Action Point 6 to needs of developing countries?

The Reports mention that developing countries and other non-OECD/non-G20 economies have been **extensively consulted** through regional and global for a meetings and their input has been fed into the work. No specific remarks were made concerning the needs of developing countries.

d. DWG's recommendations on Action 6

DWG is concerned with the **capacity of developing countries to ensure the treaty terms they negotiate are beneficial to the country**, as well as policy considerations that countries should analyse before deciding to enter into a tax treaty with another country. In this DWG calls on the OECD, IMF, UN, WBG and regional organisation, where appropriate and they are in a position to do so, to assess how to strengthen capacity development on treaty negotiation.

6.3 Action 7 Prevent the artificial avoidance of PE Status

a. Discussion Draft 31 October 2014

The concept of permanent establishment is used in domestic tax laws and tax treaties of most countries to establish a threshold that should be passed for business activities to be taxed in the

¹⁸ In one of the proposals defined as any legislation, regulation or administrative practice that provides a preferential effective rate of taxation to such income or profit, including through reductions in the tax rate or the tax base. With regard to financing income, the term special tax regime includes notional interest deductions that are allowed without regard to liabilities for such interest.

state of source. If a company resident in country A sells goods in country B it will not be taxed on the profit derived by those sales unless the company sells the goods through a permanent establishment in that country, generally defined as a fixed place of business, through which the business of an enterprise is wholly or partly carried on. The concept of permanent establishment also includes permanent representatives, habitually exercising an authority to conclude contracts in the name of their principal. Tax treaties generally exclude establishments used for preparatory or auxiliary activities, and also establishments used e.g. for the purpose of storage, display or delivery of goods, for purchasing goods or for collecting information for the enterprise. Companies may artificially avoid PE-status, e.g. by:

- a. **splitting activities;**
- b. **making use of the PE-exception;**
- c. **making use of commissionaires who sell on behalf of a foreign principal in their own or their foreign principal's name, while being legally and economically independent from the foreign principal (and thus not a permanent representative).**

These avoidance strategies were described in the Discussion Draft of 31 October 2014. This Discussion Draft also includes a number of alternative options on how to deal with these strategies.

b. Revised Discussion Draft 15 May 2015

Based on the comments received this discussion draft contains with respect to each PE avoidance strategy one specific preferred proposal.

Each of the exemptions to the PE-concept should be restricted to activities that are of a “preparatory or auxiliary” character, while adding an **anti-fragmentation rule**. Commissionaire structures should be tackled a.o. through a **new treaty provision for persons acting exclusively** or almost exclusively on behalf of one or more enterprises to which it is connected. The splitting up of contracts could best be addressed by adding an **example to the Commentary** on the Principal Purpose Test proposed in the Report on Action 6.

c. Reference concerning Action Point 7 to needs of developing countries?

Developing countries were referred to only once, to wit in respect of delivery of goods. The OECD Model contains an **exception to the right for the country of source to tax the profit**, amongst others in case the activity in its country concerns the “**delivery of its own goods for merchandise**”. This exception also applies e.g. where an enterprise maintains a very large warehouse in which a significant number of employees work for the main purpose of delivering goods that the enterprise sells online. This offers possibilities for profit shifting in case such enterprise is set up in a low tax country. **The UN Model does not contain this exemption.** Nevertheless most of the tax treaties of developing countries include the “delivery of goods” exceptions. Some countries believe that a stock of goods for prompt delivery facilitates sales of the product and thereby the earning of profit in the host country. The OECD Working Party explains that though it may be that little income could properly be attributed to this activity:

“tax authorities might be led into attributing too much income to this activity if they do not give the issue close consideration, which would lead to prolonged litigation and inconsistent application of tax treaties”.

Therefore in case a treaty is concluded by a developing country both views should be taken into account.

d. DWG's recommendations on Action 7

DWG mentions that developing countries are concerned that the interpretation of the treaty rules on Permanent Establishments allow contracts for the sale of goods belonging to a foreign company to be negotiated and concluded in the country by the sales force of a local subsidiary on behalf of that foreign company which may lead to the profits from these sales not being taxable to the same extent as they would have been if the sales were made by the local subsidiary (**commissionaire structures**).

6.4 Action 10 Assure that transfer pricing outcomes are in line with value creation – Other high-risk transactions¹⁹

a. Discussion Draft on BEPS Actions 8, 9 and 10 of 19 December 2014

A Discussion Draft on BEPS Actions 8, 9 and 10 was published on 19 December 2014 containing a proposal to revise Chapter 1 of the transfer pricing guidelines in such a way that more guidance is provided on:

- a. The accurate delineation of the actual transaction based on both the contractual arrangements and the conduct of the parties;
- b. The specification of associated risks and allocation of risk to risk management; and
- c. The non-recognition of transactions which lack the fundamental attributes of arrangements between unrelated parties.

Moreover this discussion draft contains options for potential **special measures for “residual risks”** where the new transfer pricing guidance will not be sufficient to counteract BEPS risks due to information asymmetries between taxpayers and tax administrations and the relative ease with which MNE groups can allocate capital to what is referred to in the Discussion Draft as “lowly taxed minimal functional entities (MFEs). These options concern:

- **Hard-to-value intangibles.** This concerns measures for situations where there is a potential risk for systematic mispricing in circumstances where no reliable comparables exist; where assumptions used in valuation are speculative; where information asymmetries between taxpayers and tax administration are acute; and where it is difficult to verify the assumptions on which a fixed price is agreed sometimes several years before the intangible generates income;
- **Inappropriate returns for providing capital.** Special measures are proposed as MNE groups have (except in certain regulated sectors) freedom to control their structures, including the creation and capitalisation of companies. The Working Party proposes two options for

¹⁹ Chapter 7.2 of this background paper contains information on how companies may shift profits through intercompany transactions.

capital-rich, asset-owning companies depending on another group company to generate a return from the asset. The first option would be that in case of capital-rich, asset-owning companies depending on another group company to generate a return from the asset no return would be attributed to that capital-rich, asset-owning company as the capital would be deemed to have been contributed to the company **providing the more rational investment opportunity** and that the company would be deemed to have used the capital to acquire the asset. The second option is a **thick capitalisation rule** that would reduce the profitability of the capital-rich company and produce deemed interest income in the company providing the excess capital;

- Transactions between associated enterprises where one of the parties to the transaction has **minimal functions**. The option proposes to determine thresholds of functionality. If these thresholds are not met the profits will be reallocated on the basis of one of three options proposed by the Working Party;
- **Ensuring appropriate taxation of excess returns.**

b. Discussion drafts on Action 10 of 3 November 2014 and 16 December 2014

Three discussion drafts on Action 10 were published, to wit on 3 November 2014 on low value adding services, and on 16 December 2014 on commodities as well as on profits splits.

Low value adding services concern the services an MNE group makes available to its members, including management, coordination and control functions for the whole group. The costs of providing such services, which may be initially borne by one of the group members, should be allocated to the group member to whom the service was offered. This may give concern for BEPS as it may not be easy to determine whether the service was actually provided and whether the intra-group charge for the services is in accordance with the arm's length principle. The Discussion Draft proposes guidance for determining what is a low value-adding intra-group services and how the arm's length price can be determined including a simplified benefit test, as well as on the documentation that taxpayers should prepare and submit in order to qualify for the simplified approach.

The Discussion Draft on **profit splits** concerns the application of transactional profit split methods (that is profit split per transaction as opposed to global formulary apportionment) in the context of global value chains and invites responses to questions that seek to gain insight about experiences and best practice in applying transactional profit splits and on how current guidance might be amended in order that transactional profit splits can assure that transfer pricing outcomes are in line with value creation.

In the Discussion Draft on **commodities** countries report e.g. difficulties in determining adjustments made to quoted prices, verifying the pricing date, and accounting for the involvement of other parties in the supply chain. The Discussion Draft proposes:

- (i) **additional guidance in Chapter II of the Transfer Pricing Guidelines clarifying that:**
- a. **the comparable uncontrolled price method** can be an appropriate transfer pricing method for commodity transactions between associated enterprises; and
 - b. quoted or publicly available prices ("quoted price") can be used under the CUP method as a reference to determine the arm's length price for the controlled commodity transaction.
- (ii) additional guidance in Chapter II of the Transfer Pricing Guidelines regarding the adoption of a **deemed pricing date for commodity transactions** between associated enterprises in the absence of

evidence of the actual pricing date agreed by the parties to the transactions.

c. Discussion Draft Hard-to value intangibles (Action 8)

The Discussion Draft contains a proposal for **guidance on the term “Hard-to value intangibles”** and provides that in situations where the difference between ex post outcomes and ex ante projections is significant and due to developments or events that were or should have been foreseeable at the time of the transaction tax administrations may consider **ex post evidence** about the actual financial outcomes of the transfer to be necessary in determining the appropriateness of the ex ante pricing arrangements.

d. Reference concerning Action Point (8, 9 and) 10 to needs of developing countries?

In its Discussion Draft on commodities the OECD notices that the issues may be most acute for **commodity dependent developing countries**, for which the commodity sector provides the major source of economic activity, contributing in a significant manner to employment, government revenues, income growth and foreign exchange earnings. In this discussion draft, the term “commodities” refers to physical products for which a quoted price is used by independent parties to set prices. And that in response to these issues, some countries have adopted specific unilateral approaches for pricing commodity transactions, such as the so-called **sixth method** in the Latin American region. The emergence of such approaches has highlighted the need for clearer guidance on the application of transfer pricing rules to commodity transactions.

e. DWG’s recommendations on Action 7, 8 and 9

DWG calls on the OECD, IMF, UN, WBG and regional organisations to draft a **toolkit** consisting of:

- an explanatory note, explaining how and why businesses restructure their supply chains, and the tax implications, including a description of the different supply chain models MNEs typically employ and guidance on how to identify a business restructuring has taken place;
- a paper on policy considerations in designing measures to ensure that MNEs that undergo, or have undergone, business restructuring pay the right amount of tax in each of the locations in which they operate;
- a description and analysis of the regulatory tools available to counter BEPS arising from business restructuring, including transfer pricing, permanent establishment issues, residency issues, treaty measures, anti-avoidance rules and BEPS special measures;
- guidance on the administration of regulatory measures, including how to assess the BEPS risks from the restructuring on risk assessment and practical auditing techniques;
- supporting training materials.

6.5 Action 11 Establish methodologies to collect and analyse data on BEPS and the actions to address it

a. Discussion Draft on Improving the Analysis of BEPS published on 16 April 2015

The Discussion Draft on Improving the Analysis of BEPS published on 16 April 2015 **asks the public for guidance on how to improve data for analysis of BEPS**. The lack of detail and consistency is an important issue. The Discussion Draft points out many studies of profit shifting are based on the

Amadeus database, which includes only European countries, so the results may not be applicable to non-European countries. The ORBIS database (an extensive database of almost 100 million financial accounts from many countries, that is being continually updated, expanded and improved) is based upon financial account rather than tax return data, has a Eurocentric nature and is weak in coverage of low-income countries.

b. Reference concerning Action Point 11 to needs of developing countries?

The Discussion Draft on Improving the Analysis of BEPS published on 16 April 2015 stresses the importance of a better understanding of the economic effects of BEPS on developing countries for the design of tax policies that account for country differences in tax systems and levels of enforcement capabilities. The Discussion Draft refers to a recent IMF analysis that concluded that developing countries are likely to have significantly higher BEPS concerns than developed countries due to lower tax administrative capacity to stop BEPS behaviours.

The Discussion Draft therefore pays **considerable attention to the need for more reliable data on BEPS especially for developing countries**. We quote:

“Due to limitations of the available data, both in terms of quality and quantity, as noted in Fuest and Riedel (2010), empirical research of profit shifting in developing countries is quite limited. Attempting to fill the gap on developing country studies of BEPS, Fuest, Hebous and Riedel (2011) empirically examine income shifting from developing countries by focusing on related party loans. Distinguishing between German MNE affiliates in developed and developing countries, the results show that related party debt in developing countries is significantly more sensitive to changes in corporate tax rates than in developed countries. The study concludes that profit shifting is about twice as large in developing countries as in developed economies. The IMF (2014) study on international tax spillovers uses a rough comparison of corporate tax efficiency, which suggests that revenue losses as a percent of CIT revenues in developing countries could be several multiples of those in developed countries, due to weaker enforcement resources”...

“Many studies focusing on developing countries do not separate the revenue lost from BEPS behaviours from individual tax evasion and illicit financial flows. Developing countries have higher ratios of CIT to GDP, so their revenue base is potentially more at risk from BEPS behaviours than developed countries, and loss of CIT revenue could lead to critical underfunding of public investment that could help promote economic growth. In a report by the African Tax Administration Forum (ATAF), African tax administrations find that transfer-pricing abuse is a major obstacle not only to effective revenue mobilisation, but also to development and poverty alleviation, and that most countries lack the necessary skills to identify and analyse complex cases”.

An additional concern about incomplete coverage and lack of representation arises if **BEPS behaviours differ across countries**, but the available data is only a sample of the entire population, and coverage differs by country.

The Discussion Draft points out that recently available data from the International Centre for Tax and Development (ICTD) improves comparability of data for developing countries.

c. DWG's recommendations on Action 11

DWG underlines that developing countries need data to adequately quantify tax loss from cross-border tax avoidance, and to pinpoint the sources and nature of such losses, as well as the effectiveness of measures introduced to counter them. Moreover, despite many developing countries introduced transfer pricing documentation rules they still often face challenges in obtaining the information they require to select the most appropriate taxpayers for audit, and then to effectively check or challenge their transfer pricing and other cross-border practices. DWG calls on the OECD, IMF, UN, WBG and regional organisations to draft a **toolkit of assessment of BEPS risks and effective transfer pricing documentation requirements** that balance compliance imperatives with compliance costs consisting of:

- model legislation and explanatory notes;
- reviews of country information requirements, procedures, and practices;

- supporting training materials.

6.6 Action 13 Re-examine transfer pricing documentation

a. Guidance Deliverable 16 September 2014

Transfer pricing documentation according to the 16 September 2014 OECD Report “Guidance on Transfer Pricing Documentation and Country-by-Country Reporting” has the following three objectives:

1. “To ensure that taxpayers give appropriate consideration to transfer pricing requirements in establishing prices and other conditions for transactions between associated enterprises and in reporting the income derived from such transactions in their tax returns;
2. To provide tax administrations with the information necessary to conduct an informed transfer pricing risk assessment; and
3. To provide tax administrations with useful information to employ in conducting an appropriately thorough audit of the transfer pricing practices of entities subject to tax in their jurisdiction, although it may be necessary to supplement the documentation with additional information as the audit progresses”.

Thus far there is **no standardised approach to transfer pricing documentation**. Standardisation would benefit both tax administrations and taxpayers. The OECD proposes countries should adopt a standardised approach to transfer pricing documentation consisting of:

- a. a master file containing standardised information relevant for all MNE group members;
 - b. a local file referring specifically to material transactions of the local taxpayer; and
 - c. a country-by-country report containing certain information relating to the global allocation of the MNE’s income and taxes paid together with certain indicators of the location of economic activity within the MNE group.

Thus tax administrations will be provided relevant and reliable information and the information necessary for an audit. It will benefit taxpayers as the information that should be provided in the countries involved will be standardized.

b. Report 6 February 2015

The Report “Guidance to the implementation of the Country-by-Country Report” was published on 6 February 2015. This Guidance includes that the master file and local file **should be implemented through local country legislation or administrative procedures**, and **should be filed directly with the tax administrations in each relevant jurisdiction** as required by those jurisdictions.

c. Implementation package 8 June 2015

The OECD published the Report “Guidance on the implementation of Transfer Pricing Documentation and Country-by-Country Reporting” on 8 June 2015. This Guidance provides for:

- model legislation requiring the ultimate parent entity of an MNE group to file the country-by-country report in its jurisdiction of residence, including backup filing requirements when that jurisdiction does not require filing;

- three Model Competent Authority Agreements to facilitate the exchange of country-by-country reports among tax administrations based on the Multilateral Convention on Administrative Assistance in Tax Matters, bilateral tax conventions and Tax Information Exchange Agreements²⁰

b. Reference concerning Action Point 13 to needs of developing countries?

The OECD mentions developing countries and other non-OECD/non-G20 economies have been extensively consulted. The 16 September Report mentions the view of Argentina, Brazil, China, Colombia, India, Mexico, South Africa and Turkey who state that they have difficulties in obtaining information on the global operations of an MNE group headquartered elsewhere and would like to require reporting in the country-by-country report of **additional transactional data** (beyond that available in the master file and local file for transactions of entities operating in their jurisdictions) **regarding related party interest payments, royalty payments and especially related party service fees**.

In the Implementation Package it is mentioned that developing countries may **require support** for the **effective implementation** of Country-by-Country Reporting.

e. DWG's recommendations on Action 13

Developing countries facing problems with their transfer pricing documentation rules see significant value in the revised guidance on transfer pricing documentation rules and the country-by-country template but need supplementary tools and instruments to implement the guidance.

DWG calls for a **toolkit** consisting of:

- an explanatory note, describing the role of comparable data in transfer pricing and implications of the inability to access such data;
- a description and analysis of measures developing countries might take to improve access to comparable data (such as expanding the scope and use of databases and the use of foreign comparables) or to reduce reliance on comparability data (including the use of measures and approaches such as the 'sixth method' that do not rely on the availability of such data);
- model legislation and explanatory notes, where needed;
- supporting training materials.

Moreover DWG calls for a **toolkit concerning safe harbours**, consisting of e.g.:

- an explanatory note, describing the key features of safe harbours and country approaches;
- a paper on policy considerations and implications of introducing a safe harbor regime;
- a description and analysis of regulatory options available, including developing country experience to date;
- model legislation and explanatory notes;
- guidance on the administration of safe harbours;
- supporting training materials.

Finally DWG calls on the OECD to commence a **study on the feasibility of addressing the information gap on prices of some natural minerals sold in an intermediate form**, e.g. mineral concentrate.

²⁰ Exchange of information is discussed in more detail in Chapter 10 (Exchange of Information).

Chapter 7. How to erode the tax base through financial instrument structuring and transfer (mis)pricing?

DWG in its recommendations concerning the BEPS Actions refers a number of times to the need for explanatory notes on how companies erode the tax base. Below we provide some insight into the tax planning companies seek.

7.1 Financial Instruments: how companies may erode the tax base by exploiting the difference in taxation of debt and equity

7.1.1 Different treatment of debt and equity

In order to finance their activities companies need to attract money. Roughly speaking they can acquire money by borrowing (debts) or by attracting equity. A choice for either instrument has different legal consequences. From a private law point of view a person that lends money to a company, a creditor, is entitled to repayment of the money he has lent and he is therefore not involved in the risks the company runs with its business. In most cases a creditor will require interest for lending the money. A person who provides equity to a company, usually a shareholder, participates in the business of the company in exchange for the money he provides. He is therefore entitled to (a part of) the profit the company makes. If the profit is distributed to the shareholder he receives a dividend. In case the business of a company is making losses the shareholder runs the risk of losing the money he has invested in the company. The losses may result in winding up the company and in that case the shareholder can only claim his money after the creditors of the company have been repaid. In the end the shareholder could end up with less than he invested in the company. He has no legal title to claim the difference.

The different position for private law of creditors and shareholders has resulted in a different treatment of debt and equity for corporate income tax (CIT) purposes and for taxes that are aimed at taxing the payment of interest and dividend (source taxes or withholding taxes). With respect to CIT interest paid by a company generally is deductible. However, **only few countries allow a deduction for dividend distributions to shareholders.**²¹

Creditors and shareholders are both taxed for the interest and dividend they receive. With respect to dividend this may lead to double taxation. Therefore dividend may be (wholly or partly) exempted at shareholder level. The latter will especially be the case when the shareholder is a parent company and the dividend is distributed by its subsidiary. With respect to source taxes interest and dividend may be taxed at different rates or a country may levy a source tax only on dividend (or on interest). The company paying the interest or the dividend is – when a source tax is due – usually required to withhold the tax. Source taxes actually reduce the amount of interest or dividend the creditor or shareholder receives. In domestic situations – the company and the creditor, respectively the shareholder, are resident of the same country – these taxes are usually set off against the CIT paid by the creditor or shareholder. In that case the effect of these taxes is neutralized.

²¹ As mentioned by Kevin Holmes, *International Tax Policy and Double Tax Treaties: An Introduction to Application and Principles*, IBFD, Amsterdam, 2007, p. 371. We are aware only of the notional interest deduction provided by Belgium, Italy and Turkey (effective after 1 July 2015) which offers notional expenses computed as a percentage of equity.

According to the July 2014 'OECD Report to G20 Development Working Group on the Impact of BEPS in low income countries' developing countries have expressed specific concerns that their tax bases are eroded through payments of interest on loans through:

- excessive debt financing;
- excessive pricing of debts in inter- or intracompany relations.

7.1.2 Reasons for structuring cross border financing

The tax system displayed in the previous section is applied in most countries. Ideally this would mean that if for instance interest is deducted in one country and paid to a creditor in another country it is taxed in the other country. A cross border dividend would also be treated in a similar way as a dividend paid in a domestic situation. In practice the taxation of debt and equity in a cross border situation does not always work out in a balanced way and cross border financing may be structured for tax purposes. **In general taxpayers use the following differences in tax systems** in structuring their cross border financing, to wit:

1. tax rates
2. views on what a suitable interest is
3. qualifications of financial instruments (hybrids)
4. qualifications of legal entities
5. non-deductibility of interest:

- a. because loans are wholly or mainly tax driven;
- b. because of thin capitalisation;
- c. in case of mergers and acquisitions.

Taxpayers therefore not only erode the tax base of countries through excessive debt financing or excessive pricing of inter- or intracompany debts.

ad 1 Differences in tax rates

Countries have different tax rates. CIT-rates vary all over the world: some countries have a zero or very low tax rate while others apply marginal CIT-rates that may be as high as 55% (United Arab Emirates, followed by Chad (40%) and the United States 39,1% (2014))²². These differences make it very attractive to deduct interest in a high tax country and to receive the same interest in a low tax rate country. One of the consequences is that a company in a high tax country will probably attract more debt than equity for financing its operations. This will especially be true if the creditor of the debt is part of the same group of companies as the company attracting the debt.

Example

Company X, resident in country A, is subject to a CIT of 30% in A. Company Y, resident in country B, is subject to a CIT of 15%. All shares in X and Y are held by company Z in country C. C applies a CIT rate of 20%. It also gives a tax exemption for dividends paid by resident and foreign subsidiaries.

²² <http://taxfoundation.org/article/corporate-income-tax-rates-around-world-2014>.

In case both X and Y require \$ 1 million from Z, Z will from a CIT point of view provide a loan of \$ 1 million to X and provide \$ 1 million equity to Y. If the annual return on both the loan and the equity is 5% the CIT consequences are as follows:

	Country A Company X	Country B Company Y	Country C Company Z
Interest (\$ 50.000)	Deductible; saving CIT: 30% of \$ 50.000 = \$ 15.000	x	Taxable; payable CIT: 20% of \$ 50.000 = \$ 10.000
Dividend (\$ 50.000)	x	Not deductible; payable CIT 15%	Exemption; no CIT required on the dividend.

Up to now countries may apply their own tax rates and taxpayers may in principle structure their financial position accordingly. It is obvious that the differences in CIT rates will influence the tax base of all the countries involved in such a way that the worldwide CIT burden will be as low as possible. Even if the operations of X and Y were the same the tax base – and in most cases the CIT burden – in both countries differs.

The above example may have a **more complex outcome if source taxes are levied**. Suppose country A has a source tax on interest and country B has a source tax on dividend. In that case both country A and B will increase their tax revenue while company Z in country C will receive less interest and dividend. Whether the source taxes will really be levied at the expense of Z company depends on its possibilities to set off these taxes against the CIT it has to pay in country C. If Z can set off both source taxes completely the outcome of the example will not change. Since the interest and dividend are paid in cross border situations this will not be possible in most cases. The tax burden in the example will therefore change. This may also lead to another way of financing company X and Y.

ad 2 Differences in views on what a suitable interest is

In case of a cross border loan the tax authorities of the countries involved may disagree with both each other and the taxpayers involved about the amount of interest that must be paid on the loan. Intra group loans quite often attract attention because they are contracted by related parties and the agreed interest may differ from the interest paid if the money was borrowed from a third party. The latter is deemed to be the standard because it is seen as an arm's length price for the loan that is not biased for tax reasons.

If the tax authority of a country does not agree with the interest on a intragroup loan it may adjust the interest. This may lead to an extra tax burden.

Example

Company X, a resident of A country, has borrowed \$ 100,000,000 from its parent company Y in B country at an annual interest rate of 15%. However the tax authorities of A think the arm's length rate is 10% and adjust X's tax return accordingly. This means that only 10% will be deductible for CIT in A. If A has a source tax on interest it would now be logical that this tax would also be applied to the 10% rate. The excess of 5% may then be qualified as dividend in this case and taxed with the source tax on dividend of country A. The tax authorities of B are in general not required to adjust the interest rate. They may therefore tax the interest actually received (15%). If this happens double taxation arises. If country A and B have concluded a tax treaty they may be obliged to compromise and avoid double taxation.

Since interest is the price of a loan the discussion about cross border interest within a MNE is part of the problems concerning transfer pricing. Transfer pricing in general deals with the price that is set for goods and services sold between companies that are part of the same group.

When confronted with a cross border intragroup loan it is not always clear how an arm's length interest can be determined. Especially the exchange of information between the tax administrations that have to deal with the intragroup loans is sometimes lacking or insufficient. International measures that would open up an automatic exchange of information between the relevant tax authorities would therefore be welcome.

ad 3 Differences in qualification of financial instruments (hybrids)

Countries do not always qualify a financial instrument in the same way for tax purposes. A specific financial instrument may for CIT purposes in one country qualify as a debt and in another country as equity. This can lead to double taxation or to non-taxation: a **"hybrid mismatch"**. Financial instruments that result in (double) non-taxation may also be used within a MNE.

Example

Company X, resident in country A, borrowed \$ 1.000.000 for a period of 50 years and one day from its parent company Y (the creditor) that is resident in country B. X, the debtor, pays an annual interest that is linked with X's annual profit. The loan is therefore qualified in country B as a participating loan and as a consequence the annual interest paid to Y is exempted in country B (it is treated in the same way as a dividend paid by X to Y). This is called requalification because the loan is – in contrast to its civil law status – for tax purposes treated as equity in country B. However country A may still treat the loan as a debt for its CIT. This allows X to deduct the interest paid to Y for CIT purposes. The result is that the interest is taxed in neither A nor B.

The above tax planning does not require a set of complicated legal arrangements and is easily implemented by taxpayers in cross border situations. The same is true for **cross border leasing**: country A may qualify this (financial) instrument as financial lease with tax breaks (investment allowance and depreciation for the lessee), while country B qualifies the same instrument as operational lease or rent with tax breaks for the lessor. The result is a double dip: investment allowances and depreciation in two countries.

More complex situations exist as well. An example of a **more complex situation** is a **hybrid transfer**. A **hybrid transfer** exists when a set of legal arrangements in a cross border situation is qualified differently by two or more countries. Especially a sale and repurchase arrangement (a repo), may be qualified differently. One country may deal with a repo in a rather formal way and treat it as a sale and purchase of the underlying asset, while another country considers the repo a collateralized loan. These different qualifications will once again result in a double dip if the first country in the previous sentence de facto exempts the benefits of the repo while (part of) the same benefits are treated as costs in the latter country of the previous sentence.

ad 4 Differences in qualification of legal entities

Globally speaking there is no common definition of what a legal entity is for tax purposes. This provides possibilities for tax planning through legal entities that are considered for tax purposes as opaque in one country and transparent in the other country. Like hybrid financial instruments **hybrid entities** may be used to create tax mismatches.

Example

Company X is a resident of A country. X has borrowed \$ 100,000,000 from a bank. The annual interest is 5%. X is a 100%-subsidiary of company Y, resident of B country. X is a tax subject for CIT in A country. However X is for CIT purposes

transparent in B country. This means that the possessions and debts of X are deemed to be possessions and debts of Y in B country as well.

Given these facts the annual interest of \$ 5.000.000 is deductible in A and B country. In A country X may deduct the interest because X borrowed the money and is a tax subject in A. In B country Y may deduct the interest again because it is seen as interest paid by Y. So the same interest is deducted twice (a double deduction).

In most cases the above structure is more complicated in order to take full advantage of the double deduction. Therefore X is usually the parent company of another company in A country. Suppose this is Z. X and Z will then for CIT purposes opt for group treatment in A country. This means that the interest X has to pay can be set off against the profits of Z. Therefore X and Z will just pay CIT on the difference in A country. Since only X is deemed to be transparent in B country, Y will for tax purposes in B only take into account the interest paid by X and not the profits made by Z.

Hybrid entities may also be used for cross border intra group loans or loans given to third parties in order to create a mismatch. In case of a cross border group loan the loan may not be recognized in the creditor's country but only in the debtor's country. This will occur if the creditor's country deems the debtor for tax purposes to be part of the creditor. As a consequence the loan will not exist in that jurisdiction. The debtor's country however allows interest paid on the loan to be deducted although it is not taxed in the other country. In case of a loan given to a third party the creditor may be a hybrid in the sense that is deemed to be transparent in its country of residence but it is seen as opaque in the country of its parent company. In that case the interest paid on the loan may not be taxed in both countries.

ad 5 Differences in criteria for disallowing deductibility of interest

Many Western countries **deny the deductibility of interest** in case:

- a. loans are wholly or mainly tax driven
- b. of thin capitalization
- c. of mergers and acquisitions

A loan is tax driven if a loan is contracted in order to save taxes while there is no or hardly any economic reason for contracting the loan. An example of such a loan occurs when a subsidiary declares a dividend without actually paying it to the parent company. In that case the obligation to pay the dividend will be transformed into a debt for the subsidiary. A country may deny the deduction of the interest on this debt for its CIT because there has not really been a transfer of money from the subsidiary to the parent company. In fact there has only been a mutation on the balance sheet of the subsidiary: its liabilities have increased while its net assets have dropped with the same amount.

Especially countries that have higher than average CIT-rates may be confronted with these kind of structures. To deny the deduction of interest in these cases is an effective and at first sight correct answer. However the problem is that denying the deduction of interest should only happen if it is clear that the underlying structure is really tax driven. Therefore it seems reasonable that the taxpayer who cannot deduct his interest is given the opportunity to prove that the loan – despite its appearance – has been contracted for other than tax reasons. **A clear signal that a loan is not tax driven** exists when the interest is included in the taxable income of the creditor of the loan and this income is taxed at a reasonable rate.

Many countries deny the deduction of interest in case of **thin capitalization** or **mergers and acquisitions**. Thin capitalization refers to a situation in which a company is financed through a relatively high level of debt compared to equity (thinly capitalized companies are sometimes referred to as highly leveraged or highly geared). In the case of mergers or acquisitions the acquiring company may finance the acquisition or merger mainly by debt while setting off the interest against the profit of the acquired company. In all of these cases the tax base may significantly erode. To counter this the deduction of interest may wholly or partly be denied although the debts may have been contracted for economic reasons and not for achieving tax advantages.

7.1.3 Governance initiatives to tackle BEPS through financing structuring

All of the above hybrids are nowadays discussed in international fora.

BEPS Action 2 provides a comprehensive set of proposals to counter **hybrid mismatches**. With respect to a loan that is for CIT purposes treated in the debtor's country as a debt and in the creditor's country as equity, it suggests as **primary rule** that the country of the debtor should not allow a deduction of the interest paid if this payment does not result in ordinarily taxed income in the country of the creditor. In case the country of the debtor does not apply the above primary rule – which may be possible because this country has not introduced the primary rule (in general countries are not obliged to implement the recommendations of the OECD; this is even true for OECD members) – the OECD recommends a **defensive or secondary rule**²³. This rule determines that the country of the creditor taxes the payment to the extent that it is deducted in the country of the debtor. The OECD has also discussed the use of hybrid entities within a MNE. To counter the advantage taken by MNE's it suggests as a **primary rule** that the country of the parent company, that is B country in the example under ad 4 in 7.1.2, should deny the deduction of the interest paid by the subsidiary (X (resident of A country) in the example). The OECD also suggests a **defensive rule** in case the above suggestion is not followed. It contains that the country of the subsidiary should not allow a deduction for as far a payment gives rise to a double deduction. To counteract hybrid entities used for cross border intra group loans or loans given to third parties in order to create a mismatch the OECD suggests that interest paid should no longer be deductible.

BEPS Action 4 aims at tackling base erosion and profit shifting using deductible payments such as interest that can give rise to double non-taxation by means of identifying best practices in the design of rules to prevent base erosion and profit shifting using interest and financial payments which are economically equivalent to interest. BEPS Actions 9, 10 and 13 focus on transfer pricing issues and BEPS Action 12 requires the disclosure of aggressive tax structures.

The Council of Ministers of the EU adopted a change to the **Parent-Subsidiary Directive** because of hybrid financial instruments. In general this Directive prescribes that EU-member States should not tax distributions of profit received by a parent company from its subsidiary if both companies are resident in the EU. This applies to dividends but also to the return on a hybrid financial instrument if

²³ The OECD Discussion Draft on Action 2 Neutralise the effects of Hybrid Mismatch Arrangements recommends that the "linking rules" be divided into a primary rule, which would apply whenever a hybrid mismatch arose, and a secondary or defensive rule, which would only apply in circumstances where the primary rule did not apply in the jurisdiction of the counterparty. Linking rules are defined as domestic law rules which link the tax treatment of an entity, instrument or transfer to the tax treatment in another country that has significant potential as a tool to address hybrid mismatch arrangements.

this is considered equity in the country of the parent. Since the change of the Parent-Subsidiary Directive the latter is no longer applicable if the distribution of profit has been deducted in the country of the subsidiary²⁴. EU Member States must in that case tax the distribution received by the parent company. Although this change of the Directive seems to counter mismatches caused by the use of hybrid financial instruments within MNE's effectively, this is only the case for internal EU distributions. Whether distributions coming from outside the EU will be treated the same way is up to the Member States.

Because of its many appearances it will not always be obvious that a cross border hybrid is applied within a MNE. Therefore it seems very important that tax administrations are alert when confronted with financial instruments that have characteristics of both a loan and equity or a set of legal actions that may be considered unusual or very complicated. Here the **exchange of information** between tax administrations can play a useful and role. The same applies to OECD, EU and UN initiatives concerning the exchange of information that are introduced to deal with hybrids.

7.1.4 Special considerations for developing countries required?

It seems logical that developing countries should fight the above situations in the same way as Western countries. Therefore it seems essential that **countries with less developed tax systems**:

- **take notice of the way tax systems of developed countries have been exploited** by taxpayers, among others in structuring their finance, as well as of the **anti-abuse measures** that countries with more advanced tax systems have included in their tax systems;
- **identify to which extent their tax systems might be exploited in a similar way**;
- decide on measures to counteract such abuse.

However it **requires sufficient skill and man power** to implement the necessary rules in a way that make them effective without creating overkill.

The above discussion shows that **high CIT rates make countries vulnerable** for financial structures that erode their tax base. This is especially true if interest is tax deductible. Therefore an easy way to prevent abuse may be the reduction of CIT tax rates combined with denial of the deduction of (excessive) interest. Such a policy is worthwhile looking into because it may also attract more for foreign investment. The reduction of rates should however not be too drastic as this would lead to harmful tax competition, a condition that should – as we argue in Chapter 9 – be prevented not only in EU and OECD countries.

Other alternative measures might be:

- levying **withholding tax** on interest, but not on dividend;
- introducing an **imputation system** allowing for a credit of the corporate income tax at the level of the shareholder;
- allowing for a **notional interest deduction** or for allowing the deduction of the actual amount of dividend paid; and
- introducing **deemed profit taxes**.

²⁴ The change will come in to effect for taxpayers from 1 January 2016.

Each of these measures has its cons. Due to *withholding taxes* the **administrative costs of companies increase**, making the country levying these taxes less attractive for investing in, or inducing taxpayers to find ways to circumvent these taxes, which may lead to new forms of abuse that should be tackled. An *imputation system* has the advantage of being **neutral towards financing, but is not neutral towards the place of residence of the shareholder**. *Deemed profit taxes* could result in **international mismatches** and could therefore result in double taxation or opportunities for **aggressive tax planning**. The same is true for *notional interest deductions* and for *allowing the deduction of the actual amount of dividend paid*.

7.2 Transfer pricing

7.2.1 Introduction

Transfer pricing rules serve to allocate income earned by an MNE among those countries in which it does business. The arm's length principle (ALP) is the international standard that OECD member countries have agreed should be used for determining transfer prices for tax purposes. It requires that associated enterprises must allocate income as it would be allocated between independent enterprises under comparable circumstances. By requiring a comparison with independent enterprises that operate in the open market the effect of special conditions in intra-group relations on the levels of profits should be eliminated. Many jurisdictions have enacted transfer pricing regulations, varying from an open norm plus documentation requirements (the Netherlands) to a complex set of rules (USA). Yet, the current legislation and interpretations of the ALP as described in the OECD Transfer Pricing Guidelines are not entirely suited to preventing BEPS. Companies may:

1. **Misprice** internal transactions. For tax authorities it may be difficult to recognize and challenge such mispricing;
2. **Restructure** their companies in such a way that profit is shifted to low tax countries. Therefore, the BEPS-Action Plan contains three action points on transfer pricing which aim to align transfer pricing outcomes with value creation.

7.2.2 General remarks on OECD Transfer Pricing Guidelines

In many countries the OECD Transfer Pricing Guidelines are an important source of guidance for the national legislation.

According to the OECD the consideration of **transfer pricing should not be confused with the consideration of problems of tax fraud or tax avoidance**, even though transfer pricing policies may be used for such purposes. The ALP is usually considered to be an objective rule, rather than an anti-avoidance rule. Transfer pricing adjustments are permitted if the conditions of the controlled transaction differ from those which would be made in an uncontrolled transaction, regardless of any intent of profit shifting on the part of the associated enterprises.

According to the OECD a **comparability analysis** is at the heart of the application of the arm's length principle. In a comparability analysis the controlled transactions are compared with uncontrolled transactions. The functional analysis is an important part of the comparability analysis. A functional analysis seeks to identify and compare the economically significant activities and responsibilities undertaken, assets used and risks assumed by the parties to the transactions.

The OECD acknowledges that transfer pricing is **not an exact science**. Often there does not exist just one arm's length price, but rather a range of prices that are considered to be arm's length. This offers taxpayers the opportunity to choose the most advantageous price in the arm's length range. Such tax planning, however, is not without risks in countries that have enacted stringent transfer pricing penalty regimes.

In today's business environment the individual group companies of an MNE undertake their activities within a framework of group policies and strategies that are set by the group as a whole. The ALP, however, follows the approach of treating the members of an MNE as operating as separate entities rather than as inseparable parts of a single unified business. This might be considered a flaw in the ALP. MNE's are formed precisely because it is thought to be more profitable to conduct trade through enterprises under common control than through independent enterprises. A comparison with independent enterprises may therefore not be appropriate, since associated enterprises and independent enterprises differ from each other at a fundamental level. By its nature, intra-group transactions that are not undertaken by independent enterprises are difficult to analyse under the ALP. Profits arising from **MNE-synergies**, such as economies of scale, are difficult to account for under the ALP as well, since these synergies are, by definition, not available to independent enterprises.

Increased globalization has resulted in an increasing amount of cross-border intragroup activity, adding to the importance of transfer pricing. **Global value chains** have become a dominant feature of today's global economy. Functions, assets and risks can be spread over associated enterprises located in different countries. This is of major importance, since under the ALP associated enterprises have to be appropriately remunerated for the functions performed, the assets used and the risks borne with respect to a transaction. Therefore, MNE's are incentivized to shift functions, assets and risks to low-tax jurisdictions.

Chapter IX of the Transfer Pricing Guidelines offers guidance in respect of **business restructurings**.

Despite these extensive guidelines transfer pricing is still a major concern for both tax authorities and companies. BEPS addresses three major issues:

- | |
|--|
| <ol style="list-style-type: none">1. Intangibles;2. Risks and capital;3. Other high-risk transactions. |
|--|

7.2.3 Intangibles (Action point 8)

Intangibles are of great importance in today's business environment. A large part of MNE-profits tends to be intangible-related. A major transfer pricing issue concerns the attribution of intangible-related returns to associated enterprises. Should the legal owner of the intangible be entitled to intangible-related returns or should these be attributed to the enterprises that perform the functions related to the intangibles? This issue is all the more relevant as intangibles can be transferred easily to associated enterprises located in low-tax jurisdictions.

Countries have expressed concerns that under the current guidance too much income is attributed to legal ownership.

Each transfer of intangibles among associated enterprises has to conform to the ALP. Therefore, in principle, when the profit potential of the intangibles is adequately taken into account in determining an arm's length price no profits will be shifted. However, the determination of an arm's length price for intangibles is often difficult, since comparables may not be available. In this regard information asymmetry is a concern for tax authorities. In the absence of comparables, tax authorities are largely dependent on the insights and information provided by the taxpayer. This can give rise to a risk of systematic mispricing. An enterprise might intentionally transfer intangibles for too low a price. When the intangible later on proves to be very valuable, the enterprise may attribute the difference to more favorable developments than anticipated. Since the **Guidelines prohibit the use of hindsight** (using information not yet available at the time of the transaction), these situations may be hard to deal with. In the USA the commensurate with income (CWI) standard is in place, which provides that in the case of any transfer (or license) of intangible property the income with respect to such transfer or license shall be commensurate with the income attributable to the intangible. Up to now the **OECD does not approve the CWI standard**.

Intangibles can be developed under **cost contribution arrangements (CCA's)**. According to the OECD a CCA is a framework agreed among business enterprises to share the costs and risks of developing, producing or obtaining assets, services, or rights, and to determine the nature and extent of the interests of each participant in those assets, services, or rights. CCA's may facilitate profit shifting, even if the CCA constitutes an arm's length arrangement.

Example

Company X, resident in high-tax country A, performs the substantive work of developing an intangible asset. Company Y, resident in low-tax country B, provides the requisite funding for the development of the intangible asset. Company X holds all the shares in company Y. Company Y is fully funded with equity. In this case profits may be shifted from country A to country B as company X provides funds as equity to Company Y, which in turn contributes the funds to the CCA and consequentially is entitled to a share of the intangible-related profits.

7.2.4 Risks and capital (Action point 9)

Risk allocations are of critical importance in transfer pricing, since taking on increased risk is compensated by an increase in the expected return. This entails that risk-transfers to associated enterprises in low-tax jurisdictions offer tax planning opportunities.

In an economic sense, intra-group risk-transfers are of no importance, since **the risks do not leave the group**.

That is, the outcome of the risks will ultimately hit the same shareholders, irrespective of which group-company bears the risks. In this respect, **intra-group risk transfers are not comparable to risk transfers** between independent enterprises. Yet, transfer pricing rules allow the isolation of risks at the level of particular members of the group. Risk allocations that can be undertaken include setting up limited risk manufacturers and contract researchers. In these cases risks relating to manufacturing and researching are borne by an associated company (the principal) that does not perform the manufacturing and research activities.

MNE's are usually free in their choice to capitalize group companies with either equity or debt. This gives rise to BEPS-opportunities. Companies in low-tax jurisdictions can be funded with large amounts of equity capital which can be used to acquire assets, which consequentially feature in intra-group transactions. Additionally, the equity capital can be provided as a loan to associated enterprises resulting in base eroding payments by the borrower (see Chapter 7.1 of this report).

7.2.5 Other high-risk transactions (Action point 10)

Non-recognition of transactions

According to the Guidelines a tax authorities' examination of a controlled transaction ordinarily should be based on the transaction actually undertaken by the associated enterprises as it has been structured by them.

The transactional form can only be disregarded in **exceptional circumstances**.

This implies that it may be difficult for tax authorities to challenge BEPS-facilitating transfer pricing arrangements.

Transfer pricing methods

The OECD authorizes **five methods** to arrive at an arm's length price: the comparable uncontrolled price method (CUP), the resale price method (RPM), the cost plus method (CP), the transactional net margin method (TNMM) and the transactional profit split method (PS). The CUP compares the price charged in a controlled transaction to the price charged in a comparable uncontrolled transaction. The RPM begins with the price at which a product that has been purchased from an associated enterprise is resold to an independent enterprise. This price is then reduced by an appropriate gross margin. The CP begins with the costs incurred by the supplier of property (or services) in a controlled transaction. An appropriate gross mark-up is then added to these costs. The TNMM is similar to the RPM and CP, yet provides for a net (operating) profit margin, rather than a gross profit margin. The PS first identifies the profits to be split for the associated enterprises from the controlled transactions and then splits those profits between them on an economically valid basis that approximates the division of profits that would have been anticipated and reflected in an agreement made at arm's length.

According to the **OECD** the selection of a transfer pricing method always aims at finding the most appropriate method for a particular case. Yet, if a traditional transaction method (CUP, RPM, CP) and a transactional profit method (TNMM, PS) can be applied in an equally reliable manner, the **traditional transaction method is preferable** to the transactional profit method. Moreover, if the CUP and another transfer pricing method can be applied in an equally reliable manner, the **CUP method is to be preferred**. The **United Nations does not advocate a preference for particular methods**. The most suitable method should be chosen taking into consideration the facts and circumstances.

The RPM, CP and TNMM are **one-sided methods**. Under these methods an appropriate profit margin is determined for one of the transacting parties (the tested party) by reference to the profit margins earned by comparable independent enterprises. The residual profit (or loss) then automatically

accrues to the other associated enterprise. As a consequence profits attributable to MNE-synergies, which by definition are not present in comparables, are allocated to the other associated enterprise. The PS is a two-sided method which may be more suitable than one-sided methods in reaching a more balanced allocation of profits.

The Guidelines have been accepted in international tax practice as an important tool. Nevertheless, countries can unilaterally implement other transfer pricing methods, such as the so-called '**sixth method**' which provides for the mandatory use of publicly quoted commodity prices for certain transactions involving commodity products.

Management fees and head office expenses

Services provided between associated enterprises have to be adequately remunerated. Some types of intra-group services provide specific difficulties in the application of the ALP. For example, **no comparables** are available for head office expenses which are incurred by the head office for the benefit of associated enterprises. It may be **difficult** as well **to adequately determine whether an intra-group service has been rendered**. In this regard, it is necessary to distinguish between shareholder activities and intra-group services. Shareholder activities are performed by one group member because of its ownership interest in another group member, whereas intra-group services should be beneficial for the recipient of the service.

Commodity transactions

For commodities **quoted prices** may be available. As quoted prices may be used in transactions between independent enterprises the CUP can be an appropriate transfer pricing method with respect to commodities. However, associated enterprises **sometimes make significant adjustments** to the quoted price on the grounds that the controlled transaction and the conditions taken into account in the quoted price are not sufficiently comparable. It may be difficult for tax authorities to determine the appropriateness of such adjustments. Some countries report as another BEPS-problem regarding cross-border commodity transactions that taxpayers use pricing date conventions which appear to enable the adoption by the taxpayer of the most advantageous quoted price.

7.2.6 Transfer pricing documentation (Action point 13)

Tax authorities need transfer pricing documentation in order to review a taxpayer's transfer pricing analysis. Chapter V of the Guidelines provides guidance on documentation. This guidance is of a general nature and is not binding on countries. It is therefore not surprising that countries have introduced widely varying documentation requirements in their domestic legislation. Some international attempts have been undertaken to **standardize transfer pricing documentation**. Yet, the scale of harmonization envisaged under **BEPS action point 13** is unprecedented.

7.2.7 Special considerations for developing countries

In addition to the need for improving the transfer pricing guidelines and better availability of information, we would like to stress the importance of capacity building in the area of transfer pricing. Performing audits in cooperation with experienced tax officials may be helpful to tax authorities of developing countries. The **United Nations Practical Manual on Transfer Pricing for Developing Countries** is an important tool for developing countries as well.

Chapter 8 Overview of measures available to prevent Tax Treaty Abuse

DWG in its recommendations concerning Action 4 calls for a description and analysis of regulatory actions available. As mentioned above tax treaty abuse can be prevented both through domestic law and treaty law. Below we provide an overview.

8.2.1 Domestic law: general anti-avoidance rules

General anti-avoidance rules in domestic law generally take the form of:

- a. *“substance-over-form”-rules*: this rule allows the tax authorities to ignore the legal form of an arrangement and to look to its actual substance in order to prevent artificial structures from being used for tax avoidance purposes;
- b. *“economic substance”-rules*: this rule examines whether an arrangement includes a series of steps, including a tax-motivated step that is not necessary to achieve a nontax objective; or
- c. a *General Anti-Abuse Rule (GAAR)*: a general rule describing which types of arrangements are considered as abusive and which method should be used to counteract the abuse.

E.g. the GAAR introduced in China on 2 December 2014. This GAAR is applicable if:

- i) the sole or main purpose of the arrangement is to obtain tax benefit;
- ii) the arrangement in pursuing tax benefits takes a form permissible under tax rules, but which is not consistent with its underlying economic substance.

If this is the case the tax authorities may:

- *Recharacterize* the whole or part of the arrangement;
- *Deny* the existence of a party to the transaction for tax purposes, or treat one of the parties and other parties to the transaction as one entity;
- *Recharacterize* the income, deductions, tax incentives and foreign tax credits or reallocate them between the parties to the transaction;
- Use any other reasonable method^{25, 26}.

8.2.2 Domestic law: specific anti-avoidance rules

The following specific anti-avoidance rules are typically used in domestic tax laws:

- a. *controlled foreign corporation (CFC) rules*: these rules may apply to prevent certain arrangements involving the use, by residents, of base or conduit companies that are residents of treaty countries;
- b. *thin capitalization rules*: these rules may apply to restrict the deduction of base-eroding interest payments to residents of treaty countries;
- c. *transfer pricing rules*: even if not designed primarily as anti-abuse rules such rules may prevent the artificial shifting of income from a resident enterprise to an enterprise that is resident of a treaty country;
- d. *exit or departure taxes rules*: rules that may prevent the avoidance of capital gains tax through a change of residence before the realization of a treaty-exempt capital gain; and
- e. *dividend stripping rules*: rules that may prevent the avoidance of domestic dividend withholding taxes through transactions designed to transform dividends into treaty-exempt capital gains;

²⁵ <http://www.internationaltaxreview.com/Article/3421892/China-New-guidance-on-Chinese-GAAR.html>.

²⁶ In 2013 EY referred to the following countries as having a GAAR: Australia, Brazil the Netherlands (between 1924 and 1988), Belgium, Brazil, Canada, China, France, Germany, India (proposed 2016), Indonesia, Ireland, Italy, Singapore, South Africa, South Korea, Sweden, the U.K. EY, GAAR rising: Mapping tax enforcement's evolution, February 2013, [http://www.ey.com/Publication/vwLUAssets/GAA_rising/\\$FILE/GAAR_rising_1%20Feb_2013.pdf](http://www.ey.com/Publication/vwLUAssets/GAA_rising/$FILE/GAAR_rising_1%20Feb_2013.pdf).

Not mentioned in this Report is the U.S. GAAR, that entered into effect on 30 March 2010 (§ 7701(o) of the Internal Revenue Code).

f. *foreign investment funds (FIF) rules*: these rules may prevent the deferral and avoidance of tax on investment income of residents that invest in foreign investment funds established in treaty countries.²⁷

8.2.3 Domestic law: judicial doctrines

Judges generally also may develop anti-abuse doctrines. In some countries they may do so only on the basis of anti-abuse legislation in domestic law, other countries rely largely or solely on the judiciary to both craft and adjudicate the law that limits taxpayer abuse. The judicial doctrines are general of nature. Doctrines often used are *fraus legis*, substance over form, business purpose, economic purpose, sham-doctrine. Famous examples are the UK cases *Ramsey vs. IRC (1981)* and *Furniss vs. Dawson (1984)* which established that a series of transactions with the purpose of tax avoidance which ultimately cancelled each other out could be ignored for tax purposes.

Typically, avoidance transactions may be identified by applying four tests:

- a. a **motive test** examining the purpose of a transaction. The test aims at tracing whether the taxpayer chooses an alternative structure for the transaction to help avoid or reduce tax liability, whilst achieving the same commercial goal. Examples are:
 - company capital is provided not as equity but as debt (creates a deduction);
 - dividend stripping i.e. sell share immediately before dividend distribution under the right to buy back immediately thereafter (creates conversion of dividend income into capital gain);
 - conversion of lease income into a capital gain by selling the revenue income stream as a capital item (temporary usufruct) (creates conversion of dividend income into capital gain).
- b. an **artificiality test** examining whether a complex legal series of transactions can be identified;
- c. a **benefit test** identifying whether the tax structure chosen results in relatively large benefits (money);
- d. a *justice test* testing whether the tax planning is illegitimate/against the spirit of the law.

8.2.4 Tax treaties: general anti-abuse rules

Both the OECD and the UN state that while the interpretation of tax treaties is governed by general rules that have been codified in Articles 31 to 33 of the Vienna Convention on the Law of Treaties, nothing prevents the application of similar judicial approaches to the interpretation of the particular provisions of tax treaties. Par. 30 of the UN **Commentary** to art. 1 UN Model reads:

“If, for example, the courts of one country have determined that, as a matter of legal interpretation, domestic tax provisions should apply on the basis of the economic substance of certain transactions, **there is nothing that prevents a similar approach to be adopted with respect to the application of the provisions of a tax treaty** to similar transactions”.

Nevertheless **judges may be reluctant to apply anti-abuse doctrines developed for domestic purposes to tax treaties**, as they are aware that one-sided application of an anti-abuse doctrine, that may result in making the tax treaty ineffective, is contrary to the spirit of tax treaties. Therefore such states should endeavor to include anti-abuse rules in their tax treaties.

Examples are:

- a. the anti-abuse clause in the 2010 tax treaty between the Netherlands and Panama stating:

“Nothing in this Agreement shall prejudice the right of each Contracting Party to apply its domestic laws and measures concerning tax avoidance, whether or not described as such.

²⁷ As mentioned in the Commentary to art.1 UN Model.

2. For the purposes of this Article, "laws and measures concerning tax avoidance" includes laws and measures for preventing, discouraging, avoiding or counteracting the effect of any transaction, arrangement or practice which has the purpose or effect of conferring a tax benefit on any person.

3. For the purposes of this Article, "laws and measures concerning tax avoidance" includes for the Netherlands in any case:

Article 17, paragraph 3, subparagraph b, in connection with article 17a, paragraph 1, subparagraph c, of the Corporate Income Tax Act 1969, or any identical or substantially similar provisions replacing these Articles".

- b. the anti-abuse clause in the 2012 tax treaty between the Netherlands and Germany that provides that the tax treaty does not prevent contracting states from applying their statutory domestic anti-abuse legislation and that the taxpayer may invoke a mutual agreement procedure in case such legislation results in double taxation (art. 23).
- c. the anti-abuse clause in the 2013 treaty with China stating:

"Nothing in this Agreement shall prejudice the right of each Contracting State to apply its domestic laws and measures concerning the prevention of tax evasion and avoidance, whether or not described as such, insofar as they do not give rise to taxation contrary to this Agreement" (art. 23).

Provisions similar to art. 23 of the treaty between the Netherlands and resp. Panama, Germany and China may be referred to as a general anti-abuse rule. However, as underlined in par. 35 of the Commentary to Art. 1 UN Model it cannot be said that the power to deny the benefits of treaty arises from the provision itself.

Examples of **genuine general anti-abuse rules** in tax treaties can be found e.g. in the tax 2002 tax treaty between Israel and Brazil providing:

"A competent authority of a Contracting State may deny the benefits of this Convention to any person, or with respect to any transaction, if in its opinion the granting of those benefits would constitute an abuse of the Convention according to its purpose. Notice of the application of this provision will be given by the competent authority of the Contracting State concerned to the competent authority of the other Contracting State";

and the main purpose test article in par. 36 of the Commentary to Art. 1 UN Model:

"Benefits provided for by this Convention shall not be available where it may reasonably be considered that a main purpose for entering into transactions or arrangements has been to obtain these benefits and obtaining the benefits in these circumstances would be contrary to the object and purpose of the relevant provisions of this Convention";

The UN points out that:

- a. when considering such a provision, some countries may prefer to **replace the phrase "a main purpose" by "the main purpose"** to make it clear that the provision should only apply to transactions that are, without any doubt, primarily tax-motivated. Other countries, however, may consider that, based on their experience with similar general anti-abuse rules found in domestic law, words such as "the main purpose" would impose an unrealistically high threshold that would require tax administrations to establish that obtaining tax benefits is objectively more important than the combination of all other alleged purposes, which would risk rendering the provision ineffective; and
- b. the use of such a provision would probably **be considered primarily by countries that have found it difficult to counter improper uses of tax treaties through other approaches**. Including such a provision in treaties could be interpreted as an implicit recognition that, absent such a provision, other approaches to deal with improper uses of tax treaties cannot be used. This would be particularly problematic for countries that have already concluded a large number of treaties that do not include such a provision.

8.2.5 Tax treaties: specific anti-abuse provisions

Specific anti-abuse provisions provide more certainty to taxpayers than general anti-abuse provisions.

Besides the specific anti-abuse provisions mentioned in the OECD Model and UN Model mentioned above other bilateral tax treaties often include specific anti-abuse provisions developed for the specific situation between the treaty partners. Examples are:

a. the modified version of the **limited force-of-attraction rule** of paragraph 1 of Article 7 that is found in some tax treaties and that applies only to avoidance cases. An example is art. 7(1) of the treaty between Hong Kong and Indonesia (2010):

“The profits of an enterprise of a Contracting Party shall be taxable only in that Party unless the enterprise carries on business in the other Contracting Party through a permanent establishment situated therein. If the enterprise carries on business as aforesaid, the profits of the enterprise may be taxed in the other Party, but only so much of them as is attributable to:

- (a) that permanent establishment;
- (b) sales in that other Party of goods or merchandise of the same or similar kind as those sold through that permanent establishment; or
- (c) other business activities carried on in that other Party of the same or similar kind as those effected through that permanent establishment,

provided that (b) or (c) shall not apply where an enterprise is able to demonstrate that the sales or business activities were carried out for reasons other than obtaining benefits under this Agreement”.

b. the **main purpose test** suggested in par. 21.4 of the Commentary to Art. 1 OECD Model:

“The provisions of this Article shall not apply if it was the main purpose or one of the main purposes of any person concerned with the creation or assignment of the [Article 10: “shares or other rights”; Article 11: “debt-claim”; Articles 12 and 21: “rights”] in respect of which the [Article 10: “dividend”; Article 11: “interest”; Articles 12: “royalties” and 21: “income”] is paid to take advantage of this Article by means of that creation or assignment”;

c. **general exclusion provisions** that may prevent special privileges in domestic tax law to be used in connection with the improper use of tax treaties concluded by that State (par. 21.1 Commentary to Art. 1 OECD);

d. **exclusion provisions** that prevent the tax treaty to be used in connection with special regimes in one of the two contracting States. An example is art. 29 of the treaty between the Netherlands and Luxembourg (as amended 2009) regarding “1929 holding companies” that are exempted from corporate income tax and whose dividend, interest and royalty-payments are exempted from withholding tax:

“This Convention shall not apply to holding companies (Sociétés Holding) within the meaning of the special Luxembourg laws (currently the Acts of July 31, 1929 and December 27, 1937). Neither shall it apply to income, derived from such holding companies by a resident of the Netherlands nor to shares or other rights in the capital of such companies, belonging to such a person”.

e. exclusion provisions relevant for certain **foreign-held entities** (par. 21.2 Commentary to Art. 1 OECD);

f. exclusion provisions that disallow the tax treaty to be used in case of conduit companies either by means of:

i) a **channel approach**: An example is art. 10(3) of the tax treaty between the Netherlands and Tunisia (1995):

“The provisions of paragraph 1 and subparagraph (a) of paragraph 2 shall apply under the condition that the relationship between the company paying the dividends and the recipient of these dividends is not entered into or maintained principally in order to benefit from the reduced rate referred to in subparagraph (a) of paragraph 2”.



or

ii) **a look through approach:** An example provided by the OECD in par. 13 of the Commentary to art. 1 OECD Model is:

“A company that is a resident of a Contracting State shall not be entitled to relief from taxation under this Convention with respect to any item of income, gains or profits if it is owned or controlled directly or through one or more companies, wherever resident, by persons who are not resident of a Contracting State”.

g. subject to no or low tax clauses (par. 15 Commentary to Art. 1 OECD)

The Commentary to Art. 1 OECD provides for a rule to counteract a conduit situation:

“Where income arising in a Contracting State is received by a company resident of the other Contracting State and one or more persons not resident in the other Contracting State

- a. have directly or indirectly or through one or more companies, wherever resident, a substantial interest in such company, in the form of a participation or otherwise, or
- b. exercise directly or indirectly, alone or together, the management or control of such company,

any provision of this Convention conferring an exemption from, or a reduction of, tax shall apply only to income that is subject to tax in the last-mentioned State under the ordinary rules of its tax law”.

Art. 18(2) of the treaty between the Netherlands and Ghana includes such a provision for pension payments in order to prevent that such payments are not taxed in Ghana although the premiums were deductible in the Netherlands:

“Notwithstanding the provisions of paragraph 1, a pension or other similar remuneration, annuity, or any pension and other payment paid out under the provisions of a social security system of a Contracting State, may also be taxed in the Contracting State from which it is derived, in accordance with the laws of that State:

- (a) insofar as the entitlement to this pension or other similar remuneration or annuity in the Contracting State from which it is derived is exempt from tax, or the contributions associated with the pension or other similar remuneration or annuity made to the pension scheme or insurance company were deducted in the past when calculating taxable income in that State or qualified for other tax relief in that State; and
- (b) insofar as this pension or other similar remuneration or annuity or this pension or other payment paid out under the provisions of a social security system of a Contracting State is in the Contracting State of which the recipient thereof is a resident not taxed at the generally applicable rate for income derived from dependent personal services, or less than 90 per cent of the gross amount of the pension or other similar remuneration or annuity is taxed; and
- (c) if the total gross amount of the pensions and other similar remuneration and annuities, and any pension and other payment paid out under the provisions of a social security system of a Contracting State, in any calendar year exceeds the sum of twenty thousand (20,000) Euro”.

h. provisions aimed at preferential regimes (par. 21.5 Commentary to Art. 1 OECD)

An example is included in the Protocol to the treaty concluded between the Netherlands and Panama:

“Notwithstanding Article 1, the competent authorities of the Contracting States shall by mutual agreement decide to which extent a resident of one of the Contracting States that is subject to a special regime shall not be entitled to the benefits of this Convention”.

g. limitation on benefits clauses aimed at preventing persons who are not resident of either Contracting States from accessing the benefits of a Convention through the use of an entity that would otherwise qualify as a resident of one of the States.

An example is Article 21A of the 2012 Treaty between Ethiopia and the Netherlands (included by Protocol concluded on 18 August 2014):

“1. A resident of a Contracting State shall be entitled to the benefits granted by the provisions in paragraph 2 of Article 10, paragraph 2 of Article 11 or paragraph 2 of Article 12, only if such resident is a qualified person as defined in paragraph 2.

2. A resident of a Contracting State is a qualified person only if such person is either:
 - a) an individual;



- b) a contracting state, or a political subdivision or local authority thereof;
 - c) a pension fund;
 - d) a company, provided that:
 - i) the shares of the company are regularly traded on a recognized stock exchange; or
 - ii) at least 50 per cent of the shares of the company receiving the income is owned directly by one or more companies the shares of which are regularly traded on a recognized stock exchange, but only if the last-mentioned company or companies:
 - aa) is a resident or are residents of the other Contracting State; or
 - bb) would be entitled to benefits with respect to the particular class of income for which benefits are claimed under this Convention which are similar to or more favorable than the benefits provided by this Convention pursuant to a comprehensive arrangement for the avoidance of double taxation between its or their state of residence and the Contracting State from which the benefits under this Convention are claimed or pursuant to a multilateral agreement to which its or their state of residence and the Contracting State from which the benefits under this Convention are claimed, are a party; or
 - iii) the company is engaged in the active conduct of a trade or business in the Contracting State of which it is a resident (other than making or managing investments for the company's own account, unless these activities are banking or insurance carried on by a bank or an insurance company); or
 - iv) the company is a headquarters company for a multinational corporate group which provides a substantial portion of the overall supervision, financing or administration of the group and which has, and exercises, independent discretionary authority to carry out these functions, but only if:
 - aa) the multinational corporate group consists of corporations resident in, and engaged in an active business in, at least five countries or five groupings of countries and the business activities carried on in each of the five countries (or five groupings of countries) generate at least 10 per cent of the gross income of the group; and
 - bb) no more than 50 per cent of its gross income is derived from the Contracting State other than the Contracting State of which the headquarters company is a resident
3. A company that is not a qualifying person under paragraph 2, shall, nevertheless, be entitled to the benefits granted by the provisions in paragraph 2 of Article 10, paragraph 2 of Article 11 or paragraph 2 of Article 12, if the competent authority of the Contracting State which has to grant the benefits determines that the establishment, acquisition or maintenance of such company, or of its entitlements to such benefits or the conducts of its operations does not have as its main purpose or one of its main purposes to secure such benefits.
4. The determination under paragraph 3 shall be based on all facts and circumstances including:
- a) the nature and volume of the activities of the company in its country of residence in relation to the nature and volume of the income to which the benefits to be granted relate;
 - b) both the historical and the current ownership of the company; and
 - c) the business reasons for the company residing in its country of residence.
5. The competent authority of the Contracting State which has to grant the benefits shall consult the competent authority of the other Contracting State before denying the benefits under this provision.
6. For the purposes of the provisions of paragraph 2, the term "recognized stock exchange" means:
- a) any of the stock exchanges in the member states of the European Union (EU);
 - b) any of the stock exchanges of the African Securities Exchanges Association;
 - c) any other stock exchange agreed upon by the competent authorities of the Contracting States, provided that the purchase or sale of shares on the stock exchange is not implicitly or explicitly restricted to a limited group of investors".

This rule may seem long and complex, but compared to the **extremely extensive and complex LOB-provisions** in the tax treaties the Netherlands concluded with the United States (1992) and Japan (2010) it is easy.

The treaties concluded by the Netherlands with Hong Kong (2010) and Panama (2010) provide for a 0% withholding tax rate for dividends provided certain conditions comparable to those posed in Limitation on Benefits-provisions are fulfilled, to wit:

"the beneficial owner of the dividends is:

- a) a company, the capital of which is wholly or partly divided into shares and which is a resident of the other Contracting State and holds directly at least 15 per cent of the capital of the company paying the dividends, provided that:
 - i) the shares of the company receiving the dividends are regularly traded on a recognised stock exchange; or
 - ii) at least 50 per cent of the shares of the company receiving the dividends is owned directly or indirectly by one or more individuals who are residents of either Contracting State or by one or more companies the shares of which are regularly traded on a recognised stock exchange, but only if the last-mentioned companies:
 - (aa) are residents of either Contracting State; or
 - (bb) would be entitled to benefits which are similar to or more favourable than the benefits provided by this



- paragraph pursuant to a comprehensive arrangement for the avoidance of double taxation between their state of residence and the Contracting State from which the benefits of this paragraph are claimed or pursuant to a multilateral agreement to which their state of residence and the Contracting State from which the benefits of this paragraph are claimed, are a party; or
- iii) the company receiving the dividends is engaged in the active conduct of a trade or business in the Contracting State of which it is a resident (other than the activities of making or managing investments for the resident's own account, unless these activities are banking or insurance carried on by a bank or an insurance company)"

8.2.6 Tax treaties: judicial doctrines

Legal cultures also **differ** in respect of the question **whether or not judges may apply fraud tractatis**.

In the Netherlands the Supreme Court is **reluctant** to cope with international tax avoidance through this instrument. Case law shows that the Supreme Court in such cases uses the fraud legis, so abuse of domestic law.

Chapter 9 Issues identified as relevant for developing countries not addressed by BEPS: concern about (wasteful) tax incentives

DWG pointed out that wasteful tax incentives and exchange of information are also relevant for developing countries in the discussion of base erosion and profit shifting. Below these items are addressed.

9.1 How to fight tax base erosion through (wasteful) tax incentives?

9.1.1 Introduction

According to the *July 2014 OECD Report to G20 Development Working Group on the impact of BEPS in low income countries* (part 1 and 2), developing countries have expressed **specific concerns** that their tax bases erode through (wasteful) tax incentives to attract investment. This OECD report shows there is a serious case against tax incentives in especially developing countries. The report mentions that tax incentives continue to undermine tax revenue in developing countries and that it is likely that the situation deteriorates since tax incentives have become more widespread.

9.1.2 Typical tax incentives used in developing countries

Typical tax incentives used in developing countries are tax holidays that may be limited to a certain time period, a certain industry, strategic investments (including renewable energy projects), or certain specified areas (tax free zones). Other incentives are tax rate reductions and enhanced depreciation allowances. Developing countries also grant employment incentives and export incentives²⁸. In some developing countries, according to the *July 2014 OECD Report*, forgone tax revenue because of tax incentives may be as high as 16% of GDP²⁹.

²⁸ Ghana, Myanmar, Nigeria and Vietnam use time limited tax holidays; Angola, Colombia and Indonesia provide for tax holidays for certain industries and/or strategic investments and Bolivia, Ivory Coast and Namibia have tax free zones. Vietnam offers tax incentives including time limited tax holidays and tax rate reductions to certain sectors (education, health care, sport/culture, high technology, environmental protection, scientific research, infrastructural development, software production and renewable energy). Colombia is finalizing regulations that will allow investors in renewable energy projects a discount of 50% of income tax for five years after the start of investments in renewable power or energy-efficiency projects and an exemption of VAT on all machinery and equipment, as well as services that will be used for new renewable energy projects. In its 2015 Income Tax Colombia exempts income from the sale of electric power generated from wind, biomass, or agricultural waste, for a period of 15 years, provided the seller issues and negotiates Greenhouse Gas Reduction Certificates. Colombia also offers income tax exemptions for e.g. certain tourism services, new medicinal and software products developed in Colombia and protected under new patents registered with the authorities, with a high content of national research and technology (until 2017), special tax rates for free trade zones and reductions to the CIT rate and payroll taxes for small companies. Rwanda grants enhanced depreciation allowances for certain assets; profit tax discounts ranging from 2% to 7% based on the number of Rwandans employed and maintained during a six-month period, as well as for companies that export commodities and services that bring into the country export revenue; and lower CIT rates for certain companies, including microfinance companies, venture capital companies registered with the Capital Markets Authority, and newly listed companies; and an enhanced allowance in the form of an investment allowance that is granted to investors where they incur an investment of at least RWF 30 million. See for a description of the typical features of tax systems of developing countries L. Wagenaar, *The Effect of the OECD Base Erosion*

9.1.3 Tax incentives: an effective instrument?

It is questionable whether tax incentives really increase investment, especially foreign investment. The OECD report mentions, based on a number of studies, that tax incentives **do not play a major role in attracting investment**. Tax incentives only work in a limited number of cases and moreover only in a limited number of countries. However tax incentives **should be beneficial for employment and should benefit the wider society, but may in fact benefit only few companies**³⁰. In quite a lot of cases investors would also have invested if the tax incentives were not provided.

The **design** of tax incentives is **sometimes complicated**³¹. Often the granting and administration of tax incentives is not very transparent. This is especially true if the incentives are provided for outside the countries' tax laws and are administered by different government bodies³². Sometimes they are combined with non-tax incentives and overlap or work at cross-purposes. In other cases the tax incentive may benefit taxpayers who are not the intended beneficiaries.

From an international context the effect of tax incentives may be dubious as well. First of all if a subsidiary of an MNE is granted a tax incentive **the effect of the incentive may be undone** if the country of residence of the parent company provides for a **tax credit** instead of a participation exemption.

Example

Suppose the subsidiary only pays 10% CIT instead of the regular tax rate of 25%. If the subsidiary distributes its after tax profit, the country of the parent company may not exempt the dividend but only offer a tax credit by way of avoiding international double taxation. If the regular tax rate for the parent company is 30% this company must pay 20% on the (gross) distributed profit and the tax incentive will effectively go into the treasury of the country of the parent company.

and Profit Shifting Action Plan on Developing Countries, *Bulletin for International Taxation*, 2015 (Volume 69), No. 2.

²⁹ Actionaid found in a study on tax incentives in Rwanda during the period 2002 – 2013 that Rwanda Corporate income tax would have made up 27,3% of Rwanda's tax revenues instead of 15% if they could have collected the corporation tax that was foregone due to tax incentives. Actionaid, Policy Brief, Corporate Tax Incentives in Rwanda, 5 June 2015, http://ipar-rwanda.org/index.php?option=com_edocman&view=document&id=48&catid=3&Itemid=117&lang=en.

³⁰ Actionaid found that only one of the 50 sampled companies in 2010/11 benefited from incentives that accrue from investing in a free trade zone while 4 out of the 50 companies benefited from bringing in venture capital into Rwanda. Actionaid, Policy Brief, Corporate Tax Incentives in Rwanda, 5 June 2015, http://ipar-rwanda.org/index.php?option=com_edocman&view=document&id=48&catid=3&Itemid=117&lang=en.

³¹ E.g. in her dissertation Chau Le Thi Nguyet mentions that at the time the rules in Malaysia, the Philippines and Vietnam grant the Minister of Finance, the Prime Minister or the President some power to offer incentives instead of formulating comprehensible criteria for qualification in their statutory law. Thus, the investors are uncertain whether they shall be offered incentives. The author warns that this may create misbehaviors, such as corruption, and unequal treatments between investors. Moreover the tax laws in Vietnam change fast. Therefore it is difficult for the investors to comply with the applicable rules, and they are not certain whether they shall enjoy the incentives that were offered before the changes. Chau Thi Nguyet Le, Transplants of some aspects of corporate income tax: the case of Malaysia, the Philippines and Vietnam, ac. diss., University of Groningen, the Netherlands.

³² E.g. in Nigeria tax incentives can be introduced through (different) laws, budget speeches, government notices, executed agreements, as well as Memoranda of Understanding between the government and businesses. Part 2 of a Report to G20 Development Working Group on the Impact of BEPS in Low Income Countries, OECD, 13 August 2014, pp. 30.

Secondly, according to the *July 2014 OECD Report*, an **uncontrolled race to the bottom** with ever increasing tax incentives may make all countries concerned worse off in the end. Thirdly the introduction of tax incentives may offer opportunities to artificially shift profits and deductions within MNE's. These opportunities are when exploited in developing countries not always spotted because these countries quite often lack the capacity to detect or counter detrimental tax avoidance techniques.

Although the above shows that one can have serious doubts about the use of tax incentives, it is unlikely that they will disappear completely in the foreseeable future. Therefore it is essential that **countries closely cooperate in the design of effective tax incentives** that do not worsen tax competition. E.g. accelerated depreciation is likely to be more efficient and has fewer drawbacks than tax holidays³³.

9.1.4 International governance to reduce harmful tax competition

In developed countries the OECD³⁴ and the EU³⁵ in the late nineties of the previous century set up initiatives to counter **harmful tax competition**. These were followed by **monitoring activities** in order to prevent a 'race to the bottom' of (effective) tax rates etc.

³³ Kevin Fletcher, *Tax incentives in Cambodia, Lao PDR, and Vietnam*. Prepared for the IMF Conference on Foreign Direct Investment: Opportunities and Challenges for Cambodia, Lao PDR and Vietnam, Hanoi, 16-17 August 2002, <http://www.imf.org/external/pubs/ft/seminar/2002/fdi/eng/pdf/fletcher.pdf>.

³⁴ In its 1998 Report *Harmful Tax Competition: An Emerging Global Issue* the OECD used four key factors to identify whether a preferential regime – defined as preferential in comparison with the general principles of taxation in the relevant country – is harmful:

- The regime imposes no or low effective tax rates on income from geographically mobile financial and other service activities;
- The regime is ring-fenced from the domestic economy;
- The regime lacks transparency (for example, the details of the regime or its application are not apparent, or there is inadequate regulatory supervision or financial disclosure);
- There is no effective exchange of information with respect to the regime.

The eight other factors are:

- An artificial definition of the tax base;
- Failure to adhere to international transfer pricing principles;
- Foreign source income exempt from residence country taxation;
- Negotiable tax rates or tax bases;
- Existence of secrecy provisions;
- Access to a wide network of tax treaties;
- The regime is promoted as a tax minimization vehicle;
- The regime encourages operations or arrangements that are purely tax-driven and involve no substantial activities.

The OECD focused on geographically mobile activities, such as financial and other service activities, including the provision of intangibles.

³⁵ The 1 December 1997 EU Code of Conduct for business taxation requires Member States to refrain from introducing any new harmful tax measures ("standstill") and amend any laws or practices that are deemed to be harmful in respect of the principles of the Code ("rollback"). The code covers tax measures (legislative, regulatory and administrative) that have, or may have, a significant impact on the location of business in the Union. The criteria for identifying potentially harmful measures include:

- an effective level of taxation which is significantly lower than the general level of taxation in the country concerned;

Developing countries as far as we are aware did not take such initiatives yet. However there is a serious need for it. Tax incentives may seriously erode the resources for government spending on matters that should really influence investment. For instance spending on infrastructure, education and security is sometimes substantially harmed because of lack of revenue. Another effect may be that other taxpayers have to compensate for the loss of revenue by paying significantly higher taxes. This may reduce their economic output and may also create dissatisfaction among these taxpayers.

Action 5 of the BEPS Action Plan commits the OECD Forum on Harmful Tax Practices (FHTP) to **revamp the work on harmful tax practices** with a priority on improving transparency. This includes compulsory spontaneous exchange of information on rulings related to preferential regimes. The forum will take a holistic approach to evaluate preferential tax regimes in the BEPS context. It will engage with non-OECD members on the basis of the existing framework that identifies harmful tax practices and consider revisions or additions to the existing framework. It is essential that developing countries are aware of the benefits of such international coordination, preventing harmful tax competition.

9.1.5 Domestic initiatives

It is also essential that developing countries critically analyze their domestic legislation and determine whether they may benefit from reducing the number of tax incentives. It is also important to determine whether tax incentives granted are rightfully granted. A good example is Rwanda, which country as a result of recommendations of Actionaid and Tax Justice Network Africa's 2011, now **closely monitors whether there is no abuse of time-limited tax incentives by companies** that:

- ask for and are granted these incentives beyond the time period;
- change ownership or rebrand assets after the time period, thus registering for fresh periods³⁶.

9.1.6 Principles to enhance transparency and governance of tax incentives for investment in developing countries

The OECD Working Group on the impact of BEPS in low-income countries formulated the following principles to enhance the transparency and governance of tax incentives for investment in developing countries. **Developing states should:**

1. **Make public a statement of all tax incentives** for investment and their objectives within a governing framework;
2. Provide tax incentives for investment **through tax laws only**;

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- tax benefits reserved for non-residents;
 - tax incentives for activities which are isolated from the domestic economy and therefore have no impact on the national tax base;
 - granting of tax advantages even in the absence of any real economic activity;
 - the basis of profit determination for companies in a multinational group departs from internationally accepted rules, in particular those approved by the OECD;
 - lack of transparency.

³⁶ Actionaid, Policy Brief, Corporate Tax Incentives in Rwanda, 5 June 2015, http://ipar-rwanda.org/index.php?option=com_edocman&view=document&id=48&catid=3&Itemid=117&lang=en.

3. **Consolidate all tax incentives** for investment under the authority of one government body, where possible;
4. Ensure tax incentives for investment **are ratified through the law** making body or parliament;
5. Administer tax incentives for investment in a **transparent** manner;
6. **Calculate the amount of revenue forgone** attributable to tax incentives for investment and publicly release a statement of tax expenditures;
7. Carry out **periodic review** of the continuance of existing tax incentives by assessing the extent to which they meet the stated objectives;
8. **Highlight the largest beneficiaries** of tax incentives for investment by specific tax provision in a regular statement of tax expenditures, where possible;
9. **Collect data** systematically to underpin the statement of tax expenditures for investment and to monitor the overall effects and effectiveness of individual tax incentives;
10. **Enhance regional cooperation** to avoid harmful tax competition.

To this **we would like to add:**

1. Tax incentives do not only imply foregone revenue, but also may – as intended – benefit the economy. Therefore states should identify in the best possible way the benefits and costs in terms of loss of revenue and unintended use;
2. States should monitor closely whether tax incentives are granted in line with the law;
3. States should compare tax incentives provided with those provided in e.g. EU Member States and participate in the OECD international co-operation initiative to avoid harmful tax competition;
4. States should avoid the undoing of the intended effect of (useful) tax incentives by applying participation exemption instead of preventing double taxation by means of a tax credit.

Chapter 10 Issues identified as relevant for developing countries not addressed by BEPS: exchange of information

10.1 Introduction

No taxation system will operate without information being accessible to the tax authorities responsible for the levying of taxes. Even where the responsibility for the assessment and the payment of taxes is primarily laid in the hands of the taxable (legal) person, control will have to be applied afterwards to ascertain that persons compliance with tax law. Control is not possible without information and so the right to demand information from taxable persons is one of the most important competences of any tax authority. This right to information usually means that the taxable persons will have to:

- **answer questions in relation to their tax affairs;**
- **disclose any documents in relation to these affairs;**

In most states some or all third parties such as business partners or banks that have information on a taxable person are also obliged to provide information on the taxpayer to the authorities.

These rights to information however are only effective in a national context. As soon as some or all of the relevant information is held outside the state the tax system of which is concerned, tax authorities of the levying state will have great difficulty in obtaining that information or even getting aware that the information exists. This is the case if the information is held by the taxable person and even more so if it is held by a third party. In line with one of the basic principles of international public law the boundaries of any state will also set the boundaries to the competence of the tax authorities of that state to impose obligations on individuals and legal persons or at least to enforce the fulfillment of these obligations. If an official of state A wishes to obtain information that is only available in state B there are two possibilities. The first one is to **compel the taxable person** that is based in state A to provide the information under some threat of penalty. The other is **to ask state B** to gather the information using its own competences on behalf of state A and then providing it to said state A.

This Chapter:

- Provides general information on the exchange of information between states that is relevant for taxation purposes.
- Specifically identifies problems that developing countries meet in obtaining information and when dealing with exchange of information on a large scale.

10.2 Forms of exchange of information

Three forms of exchange of information are commonly recognized. These are **automatic exchange**, **spontaneous exchange** and **exchange of information on request**. Each of these forms has its own field of application.

Automatic exchange of information is most widely used to communicate large numbers of standard data, such as data on bank accounts and the like. Spontaneous exchange of information is effective

whenever the tax authorities of the providing state feel that they have access to information relevant for the tax authorities of another state, provided that some kind of agreement between the two states is in force that makes the exchange of information possible or even compulsory. Finally, exchange of information on request takes place whenever the tax authorities of the state asking for the information feel that information that will be useful to them in levying taxes from one of their citizens or residents, is present in another state but not available to themselves. All of these forms of exchange are governed by widely accepted sets of rules. There still seems to be some confusion on the nomenclature regarding spontaneous exchange of information. Spontaneous in the narrow sense of the word in our opinion means: without any outside pressure. As soon as treaty obligations force the exchange of information, spontaneous does not seem to be the right expression. We would recommend calling this kind of information exchange **“compulsory exchange of information”**. Hereafter we will use this terminology. This means that one could argue that there are not three but four types of information exchange in existence. The exchange of information has been an accepted practice in international tax law. Both tax treaties between developed countries as well as tax treaties between developing countries or between a developed country and a developing country include exchange of information provisions, generally based on a provision the same or similar to **art. 26 OECD Model, or art. 26 UN Model**³⁷. Exchange of information can also take place on the basis of the **OECD/Council of Europe multilateral Convention on Mutual Administrative Assistance in Tax Matters** or on the basis of **EU-Directives** (most recent Directive 2011/16). See Annex 2 for an overview of international governance initiatives concerning exchange of information.

A major breakthrough towards more transparency was accomplished in 2009 with information exchange upon request becoming the international standard and the Global Forum on Transparency and Exchange of Information for Tax Purposes starting to monitor the implementation of the standard through peer reviews.

10.3 Automatic exchange of information and developing countries

Automatic exchange of information is based on bi- or multilateral treaties. It comprises financial data regarding bank accounts and for instance some insurance contracts. The amount of data is large, since all information regarding non-residents of the providing country is sent to the countries where the account holders etc. are deemed to be resident. This means that automatic exchange requires a tax system that is fully developed and well implemented. The local banking systems and other financial institutions must be highly automated for automatic exchange to work well. Although the information exchanged is provided to the other state by the proper tax authorities, the information itself is usually generated by third parties, mostly without any form of remuneration or even compensation of costs. This is a reason why automatic exchange is not as widespread yet as the other forms are. Although measured in amounts of information, automatic exchange accounts for by far the highest amount of data, measured in numbers of countries involved, automatic exchange is still something of an exception on world scale. **Standardisation** offers process **simplification, higher effectiveness and lower costs for all stakeholders concerned** for the global problem of tax evasion.

³⁷ Reading similar with the exception that the OECD Model also rules that the information may also be used for other purposes than for the assessment or collection of or the determination of appeals in relation to taxes if such information may be used for such other purposes under the laws of both States and the competent authority of the supplying State authorizes such use.

In 2014 the OECD Global Forum on Transparency and Exchange of Information for Tax Purposes was commissioned by the G20 to prepare a new technical standard for the automatic exchange of information³⁸ and to assist member countries in adopting these standards³⁹. About half the world's states (including developing countries) are members of this forum, so automatic exchange may well have a very bright future. The standard consists of two components:

- a) the **Common Reporting Standard**, which contains the reporting and due diligence rules; and
- b) the **Model CAA**, which contains the detailed rules on the exchange of information.

The financial information to be reported with respect to reportable accounts includes all types of investment income (including interest, dividends, income from certain insurance contracts and other similar types of income) but also account balances and sales proceeds from financial assets. The financial institutions that are required to report under the CRS do not only include banks and custodians but also other financial institutions such as brokers, certain collective investment vehicles and certain insurance companies. Reportable accounts include accounts held by individuals and entities (which includes trusts and foundations). The standard moreover includes a requirement to look through passive entities to report on the individuals that ultimately control these entities.

As we mentioned before, the large amounts of information **require a well-developed and well implemented tax administration system**. Data will be provided digitally and the means to process these data and then put them to use must be present for any information exchange to be useful. For many developing countries, even if they are members of the Global Forum, automatic exchange will not be particularly useful because of a lack of processing possibilities.

On the other hand one must also remember that the **financial information that automatic exchange provides is relevant for a comparatively small part of the population of developing countries**, to wit those that are in a position to place their wealth outside of their home countries. This would mean that the amount of data involved might be small enough to be handled by the local tax administration after all. Still, this administration will have to be able to technically process the digital data provided.

Interestingly, the **European Parliament has passed a resolution that it will actively promote to get automatic exchange of information included in the OECD Good Governance Standard in 2010**⁴⁰. And in 2014 the United Nations Committee of Experts on International Cooperation in Tax adopted for consideration by the Economic and Social Council (ECOSOC) a **proposed United Nations Code of Conduct on Cooperation in Combating International Tax Evasion** in which it:

- endorses the work and recent developments carried out on automatic exchange of financial account information in tax matters (the CRS);
- encourages all countries that have not already done so to sign and ratify the multilateral Convention on Mutual Administrative Assistance in Tax Matters;
- commits to work with the OECD, the Global Forum on Exchange of Information

³⁸ <http://www.oecd.org/ctp/exchange-of-tax-information/automatic-exchange-financial-account-information-common-reporting-standard.pdf>.

³⁹ Global Forum on Transparency and Exchange of Information for Tax Purposes, Tax Transparency 2014, Report on Progress, p. 8, <http://www.oecd.org/tax/transparency/GFannualreport2014.pdf>.

⁴⁰ European Parliament, Resolution on Promoting Good Governance in the Area of Taxation, 10 February 2010, 2009/2174(INI).

for Tax Purposes, the G20 and other concerned multilateral bodies and relevant international organizations in order to help developing countries and countries with economies in transition to identify their needs for capacity building and technical assistance on automatic exchange of information (including confidentiality);

- commits also to conduct technical meetings, seminars and other **capacity building** or **technical assistance** events on automatic exchange of information (including confidentiality) for developing countries and countries with economies in transition, with concerned multilateral bodies and relevant international organizations.

10.4 Automatic or compulsory exchange of information on rulings

A form of automatic exchange of information that could be relevant to developing countries is the **automatic notification of all states concerned of any tax rulings** that one of these states has concluded with any individuals or business companies active in the states concerned. In fact, this kind of information exchange may be named automatic but more rightly should be called compulsory, as no automatism in the technical sense will be implemented. In rulings or tax agreements, tax authorities lay down the provisions under which a company wishing to carry on a certain kind of business activity within that state's area of competence, may gain certainty as to the tax consequences. These agreements may for instance rule the amount of profit to be taxed in the state of residence, the interest spread to be taken into account between money borrowed and money lent, the amount of royalties paid that are acceptable etc. Both developing countries and developed countries provide for tax rulings and conclude agreements with business companies. E.g. in the Netherlands, these rulings often concern the amount of interest to be taken into account for intracompany financing, management fees for intermediate holding companies and the question whether the participation exemption can be applied. In developing countries, tax agreements will more often be concluded with subsidiaries of multinationals having their head office in a developed country and such subsidiaries – active in the developing country - may be given favorable tax conditions in order to promote investments. In both situations the state where another company belonging to the same group resides will be interested in the tax rulings given, for instance to be able to assess whether transfer prices are at arm's length. This again is vital in judging the correctness of the profits declared by locally active companies. Not only the subjects of the rulings vary, but also the conditions to be fulfilled and the checks and balances to ensure that such rulings are in line with the law and do not give beneficial treatment to certain taxpayers⁴¹.

General rulings appear to pose less of a risk than specific rulings since they are often published and therefore conditions of applicability are available. Thus such rulings are transparent.

The EU Commission presented a package of measures to boost tax transparency (**the Tax Transparency Package**) on 18 March 2015. Part of this package is a proposal for automatic exchange of tax rulings with the exception of domestic tax rulings and rulings with individuals. The tax authorities of the Member States will be required to send a short report to all other Member States on all advance cross-border tax rulings and advance transfer pricing arrangements that they have issued so that the other Member States can detect certain abusive tax practices by companies and

⁴¹ In the Netherlands e.g. the four eyes principles requires rulings to be signed by more than one tax inspector.

take the necessary action in response. If, after this initial exchange, a Member State believes that it needs more information on a particular ruling, it can request more details or the full ruling. On its website the EU mentions the increased transparency will furthermore exert peer pressure on Member States to adapt their national tax practices and allow them to take actions against harmful tax practices applied in other Member States.

Under the current proposals it will **not be possible for a Member State to refuse to exchange general information on tax rulings on grounds of commercial secrets**, as such interests would be adequately protected under EU law. If a Member State asks for more specific information the exception will probably not apply.

10.5 Spontaneous exchange of information: art. 9 EU Directive 2011/16/EU as example

Spontaneous exchange of information that is not compulsory provides tax authorities of the contracting parties with a wide degree of freedom in determining whether any piece of information is important enough to warrant sending it to their counterpart in the other contracting state. It stands to reason that a friendly diplomatic relationship between the contracting parties will help in lowering the barrier between the states and make providing information easier.

Spontaneous exchange of information can be accomplished quite easily. **However tax authorities rightly or wrongly may feel very much obliged to protect the privacy of their tax subjects.** In many countries (such as the Netherlands) fiscal information is regarded as secret and it is an offence for any tax official to disclose any information regarding tax subjects that he or she has gained in relation to their work. This secrecy is formally broken by the information exchange articles in bi- or multilateral tax treaties, but to share information with an official not belonging to one's own organization may well feel unnatural and uncomfortable. The fact that any illegal breach of secrecy is punishable by law does not help in this respect of course. When it is unclear if the information provided will be used as intended or if there are doubts if the receiving authorities are completely trustworthy, the officials that could send the information will probably rather be safe than sorry and will withhold the information however useful it might be.

As an **example of what we consider good design** we have included the situations where art. 9 Directive 2011/16/EU compels the competent authorities of any member state to provide spontaneous information to another member state where the scope of and conditions for spontaneous exchange of information are provided. Besides allowing competent authorities of each Member State to communicate, by spontaneous exchange, to the competent authorities of the other Member States any information of which they are aware and which may be useful to the competent authorities of the other Member States, **this article obliges** competent authorities of each Member State to **communicate the foreseeable relevant information** to the competent authority of any other Member State **in any of the following circumstances**:

- | |
|---|
| <ol style="list-style-type: none">a. The competent authority of one Member State has grounds for supposing that there may be a loss of tax in the other Member State;b. A person liable to tax obtains a reduction in, or an exemption from, tax in one Member State which would give rise to an increase in tax or to liability to tax in the other Member State; |
|---|

- c. Business dealings between a person liable to tax in one Member State and a person liable to tax in the other Member State are conducted through one or more countries in such a way that a saving in tax may result in one or the other Member State or in both;
- d. The competent authority of a Member State has grounds for supposing that a saving of tax may result from artificial transfers of profits within groups of enterprises;
- e. Information forwarded to one Member State by the competent authority of the other Member State has enabled information to be obtained which may be relevant in assessing liability to tax in the latter Member State.

This seems a good example of formalizing a procedure that in our opinion should be standard between friendly states.

10.6 Exchange of information on demand

The third (or if one wishes, fourth) and most widely spread method of exchanging information is exchange on demand. In this case the state that needs information for the correct assessment of taxes to be levied from its residents will take the initiative to request the information from another state. This request must be based on a bi- or multilateral treaty or e.g., in a European context, on supranational law. Without such a legal basis, no state will provide information on its own subjects or residents to another state. In the past this has been a major obstacle in the struggle against tax evasion, since taxable income or wealth was commonly transferred to countries that were not part to any tax treaties containing information exchange provisions. The economies of these so called tax havens were to some extent driven by financial and tax services to foreign tax evaders. In the last few years there has been a change of climate regarding this kind of disruptive economic behavior. The OECD published a **Model Tax Information Exchange Agreement (TIEA)** in 2002. It also published lists of countries considered to be tax havens, judging all countries by a set of rules to which they would have to comply to not be qualified as a tax haven. Among these rules is the willingness to supply information on request regarding so-called off-shore business activities and regarding capital deposited with financial institutions in the country. An important secondary rule is that no local legal rules on bank secrecy may prevent the exchange of information on request. This Model TIEA has proven to be a resounding success. Apparently no states will run the risk of economic damage or even sanctions because of a qualification as a tax haven. On the OECD website the following statement can be found:

“In a report issued in 2000, the OECD identified a number of jurisdictions as tax havens according to criteria it had established. Between 2000 and April 2002, 31 jurisdictions made formal commitments to implement the OECD’s standards of transparency and exchange of information. Seven jurisdictions (Andorra, Liechtenstein, Liberia, Monaco, Marshall Islands, Nauru and Vanuatu) did not make commitments to transparency and exchange of information at that time and were identified in April 2002 by the OECD’s Committee on Fiscal Affairs as unco-operative tax havens. All of these jurisdictions subsequently made commitments and were removed from the list of unco-operative tax havens. Nauru and Vanuatu made their commitments in 2003 and Liberia and the Marshall Islands in 2007. **In May 2009, the Committee on Fiscal Affairs decided to remove all three remaining jurisdictions (Andorra, Liechtenstein, Monaco) from the list of uncooperative tax havens** in the light of their commitments to implement the OECD standards of transparency and effective

exchange of information and the timetable they set for the implementation. As a result, no jurisdiction is currently listed as an unco-operative tax haven by the Committee on Fiscal Affairs.”⁴²

Not being listed as an unco-operative tax haven only implies that the state concerned conforms to a minimum of co-operation and will exchange information on demand. No bank secrecy clauses will be invoked and no information will be withheld on the grounds that the state has no interest itself.

The practical form this co-operation has taken is the conclusion of Tax Information Exchange Agreements (TIEA's)⁴³. The Netherlands for instance have concluded 28 TIEA's to date, all with small countries, many of which would be deemed tax havens before 2002 (e.g. Bahamas, Bermuda, Cayman Islands, Jersey, Guernsey). The Global Forum on Transparency and Exchange of Information for Tax Purposes by means of a **peer review** of the tax legislation of countries **monitors the implementation of the standards of transparency and exchange of information** for tax purposes that provide for international exchange on request of foreseeably relevant information for the administration or enforcement of the domestic tax laws of a requesting party. As soon as larger countries with an economy of any scale are involved, general tax treaties are the preferred means of regulating the fiscal relationship between states. These general tax treaties will practically always contain provisions regarding the exchange of information. In older treaties this exchange may be limited to matters regarding the working of the treaty itself. In recent treaties that follow the OECD Model Convention, the exchange will always also regard the assessment of domestic taxes by the countries involved.

One of the **main disadvantages of exchanging information on demand** is the fact that the requesting state must first be aware of a need for information before it can ask for it. As long as a taxable person succeeds in keeping all knowledge about tax evading schemes from the competent tax authorities, these authorities could only put very general questions to their treaty partners. Those treaty partners however will normally only answer specific questions clearly relevant for the correct taxation of a named taxable person or entity in the requesting country. “Fishing expeditions” where tax authorities search for information in a more or less random way in the hope of finding evidence of until then undiscovered tax evasion are not covered by the information exchange provisions of tax treaties nor of TIEA's. Therefore there must exist an equilibrium between exchange of information on demand and the spontaneous exchange of information that may in many cases give tax authorities a first hint of tax evasion schemes that are in operation under its jurisdiction.

10.7 Specific needs of developing countries: tools to obtain information regarding transfer pricing including Country-by-Country Reporting (BEPS Action 13)

Developing countries are known to have **difficulties in obtaining relevant information** regarding for instance intercompany pricing. This problem is recognized in the *OECD Report to G20 development working group on the impact of BEPS in Low Income Countries*. In this report, the implication for developing countries is defined as follows: “Need for development of international standards and guidance on transfer pricing documentation and information reporting, including a common template for country by country reporting to tax administrations, that enable developing countries to

⁴² <http://www.oecd.org/countries/monaco/listofunco-operativetaxhavens.htm>.

⁴³ <http://www.oecd.org/tax/exchange-of-tax-information/2082215.pdf>.



obtain the information needed to assess the risk of transfer pricing abuse, and effectively address such risk”.

Action 13 of the OECD BEPS-Action Plan concerns Country-by-Country Reporting. Country-by-Country Reporting can be referred to as a different approach to automatic exchange of information specifically aimed at multinational enterprises (MNE’s) and their allocation of costs and profits. This initiative was taken up by the G8 which called on the OECD to develop a **common template for Country-by-Country Reporting to tax authorities by MNE’s**. Many developing countries see the value of this work in helping them to assess the risks of profit shifting. Country-by-Country Reporting will only apply to large companies with over 750 million Euros turnover. The data generated will not be publicly available and will be exchanged through tax treaties. In order to benefit from this initiative it is essential that developing countries conclude tax treaties, especially if they rely for their tax revenue heavily on the contributions of MNEs⁴⁴.

10.8 Exchange of information: capacity constraints

No doubt, just like for developed countries, exchange of information is an important tool in tackling base erosion and profit shifting. However capacity countries may limit the effectiveness.

⁴⁴ The OECD reports in its *Report to G20 Development Working Group on the impact of BEPS in low income countries*, July 2014 that in Burundi one company contributes nearly 20% of total tax collection; in Peru related party transactions account for 26% of GDP; in Rwanda 70% of the tax base and in Nigeria 88% of the tax base comes from MNEs.

ANNEX 1: OVERVIEW OF BEPS ACTION POINTS AND PUBLICATIONS (12 JUNE 2015)

BEPS Action points	Most recent publications	Still to be published
1. Digital economy	Report on 16-09-2014	Follow up work by 2015
2. Hybrid mismatch arrangements	Report on 16-09-2014	Commentary on the recommended domestic provisions by 2015
3. CFC-rules	Discussion draft on 03-04-2015	Final report by September 2015
4. Interest deductions and other financial payments	Discussion draft on 18-12-2014	Final report by September 2015 Report on Transfer pricing aspects of financial transactions
5. Harmful tax practices	Report on 16-09-2014 Agreement on Modified Nexus Approach for IP Regimes on 06-02-2015	Final report by September 2015
6. Treaty abuse	Report on 16-09-2014 Revised discussion draft on 22-05-2015	Final report by September 2015
7. Artificial avoidance of PE-status	Discussion draft on 31-10-2014 Revised discussion draft on 15-05-2015	Final report by September 2015 Guidance on profit attributions to PE's in 2016
8. Transfer pricing – intangibles	Report on intangibles on 16-09-2014 Discussion draft on CCA's on 29-04-2015 Discussion draft on hard-to-value intangibles on 04-06-2015	Final report by September 2015
9. Transfer pricing – risks and capital		Final report by September 2015
10. Transfer pricing – other high-risk transactions	Discussion draft on low value adding services on 03-11-2014 Discussion draft on commodities on 16-12-2014 Discussion draft on profit splits on 16-12-2014	Final report by September 2015
8-10 Transfer pricing	Discussion draft on revisions to chapter I of the Transfer Pricing Guidelines on 19-12-2014	Final report by September 2015
11. Methodologies for data collection and analysis	Discussion draft on 16-04-2015	Final report by September 2015
12. Mandatory disclosure rules	Discussion draft on 31-03-2015	Final report by September 2015
13. Transfer pricing documentation	Report on 16-09-2014 Guidance on implementation on 06-02-2015 CbC implementation package on 08-06-2015	XML Schema and a related user Guide will be developed with a view to accommodating the electronic exchange of CbC Reports
14. Dispute resolution	Discussion draft on 18-12-2014	Final report by September 2015
15. Multilateral instrument	Report on 16-09-2014 Mandate for the Development of a Multilateral Instrument on 06-02-2015	Conclude the multilateral instrument and open it for signature by December 2016

ANNEX 2: OVERVIEW OF INTERNATIONAL GOVERNANCE INITIATIVES CONCERNING EXCHANGE OF INFORMATION

a. Art. 26 of the OECD Model Convention

The main provisions of art. 26 of the OECD Model Convention are the following:

“1. The competent authorities of the Contracting States shall exchange such information as is foreseeably relevant for carrying out the provisions of this Convention or to the administration or enforcement of the domestic laws concerning taxes of every kind and description imposed on behalf of the Contracting States.....

2. Any information received under paragraph 1 by a Contracting State shall be treated as secret in the same manner as information obtained under the domestic laws of that State

These paragraphs are supplemented by clauses regarding on the one hand the waiving of any legal restrictions because of bank secrecy, and on the other hand clauses restricting the obligations to provide information to the use of legal and administrative means available according to the national law of the requested country.

Under art. 26 all the methods of exchanging and providing information mentioned above may be used. As long as the national law of the contracting states allows the gathering of the information requested, it will have to be provided on request. If one of the states wishes to provide information spontaneously or if both contracting states wish to exchange information automatically, art. 26 does not prevent this. Some problems might arise regarding the secrecy of the information provided if the receiving state maintains a lower level of secrecy than the providing state. This will be all the more so if secrecy is not kept to the legally required standards in practice. As we remarked before, a requested state will be reluctant to provide information if there is a real or perceived risk that the information will become more or less public in the requesting state.

b. The OECD Model TIEA

In the Model TIEA only exchange of information on request is regulated. This is regulated in much more detail than in art. 26 of the Model Convention. On the topic of exchange on request, the Model TIEA however, essentially does not differ from art. 26. Where it does differ is in also providing for Tax examinations abroad. In a tax examination abroad, tax officials of one state are allowed on request to enter the other state to examine a resident of that other state. This requires specific treaty provisions as normally no official of any state is allowed to exercise any power on the territory of another state. The power to examine a person or a legal body is restricted by the proviso that written consent of the person to be examined is required.

TIEAs have become quite popular since the publication of the Model in 2002. Their popularity can in part be explained by their relatively restricted function. Since TIEAs only regulate exchange of information on request in individual cases, they do not place a very high burden on the small low income states that usually conclude them with larger and more developed states. As we have stated before, exchange of information on demand does have its limitations. The most important limitation being that if tax evasion schemes do not become known to tax authorities in some other way, there will be no motive to request information however relevant it might be.

c. The UN Model Treaty

Although the wording of art. 26 of the UN Model Double Taxation Convention between developed and developing Countries is to a very large extent the same as art. 26 of the OECD Model Convention it is **intended to be broader in a number of respects than the comparable provision in the OECD Model Convention**. This is reflected in two deviations in the text. The first is an added sentence in the first paragraph: “In particular, information shall be exchanged that would be helpful to a Contracting State in preventing avoidance or evasion of such taxes.” The second is an added paragraph 6: “The competent authorities shall, through consultation, develop appropriate methods and techniques concerning the matters in respect of which exchanges of information under paragraph 1 shall be made.”

In paragraph 4.3 of the comment on the Model Treaty, **the meaning of the addition to paragraph 1 of art. 26 is explained**: “Although tax evasion is illegal and tax avoidance is not, both result in loss of revenue to the government, and, by definition, both defeat the intent of the government in enacting its taxing statutes. Consequently, mutual assistance in combating tax avoidance is an important aspect of mutual cooperation on tax matters. In addition, some forms of aggressive tax avoidance are so close to the line between avoidance and evasion that a Contracting State is unlikely to know for sure whether the information it is requesting deals with avoidance or evasion until after it obtains the requested information. Information on tax avoidance may be extremely useful to a Contracting State in its efforts to close possible loopholes in its taxing statutes.”

The comment makes **clear that the obligation to exchange information extends itself to spontaneous exchange in cases where tax avoidance or tax evasion are likely**. This makes the provisions on information exchange in the UN Model Treaty potentially **much more effective** than those in the OECD Model Convention, although art. 26 of the OECD Model Convention does not prevent spontaneous exchange.

The second addition specifies the ways in which information may be exchanged. According to the commentary: “This language authorizes the competent authorities to exchange information in at least three modes: exchange by specific request, automatic exchange, and other exchanges, understood to include spontaneous exchanges.”

d. The OECD/Council of Europe Multilateral Convention on Mutual Administrative Assistance in Tax Matters

The Multilateral Convention on Mutual Administrative Assistance in Tax Matters has been developed jointly by the OECD and the Council of Europe. It was opened for signature in 1988 and has been amended by a Protocol in 2010. The convention provides for exchange of information (on request, automatic and spontaneous) as well as for a.o. simultaneous tax examinations, tax examinations abroad, assistance in recovery and the service of documents. By a Protocol of 2010 the Convention has been opened to all countries. According to the OECD the Convention has taken on increasing importance following the G20’s call for automatic exchange to become the new international standard of the exchange of tax information, and the subsequent development of the Standard for Automatic Exchange of Financial Account Information.⁴⁵

⁴⁵ <http://www.oecd.org/ctp/exchange-of-tax-information/conventiononmutualadministrativeassistanceintaxmatters.htm>.

e. The OECD Multilateral Competent Authority Agreement on Automatic Exchange of Financial Account Information

In 2014, The OECD Multilateral Competent Authority Agreement on Automatic Exchange of Financial Account Information came into effect. According to the OECD website 54 jurisdictions had signed the Agreement on the 4th of June 2015. Most of the signing states are developed countries. The OECD expressly urges developing countries to sign the Agreement too. The Agreement obliges the signing countries to **automatically exchange** among each other all information regarding financial accounts held in these countries. The technical standards that are to be adhered to are the Common Reporting Standards also published by the OECD. This may be a reason why developing countries are not rushing to sign the agreement. The tax administrations of these countries, as well as the administrative departments of their financial institutions, may well be incapable of guaranteeing the quality of their administrative processes to be of the quality demanded by the OECD. This leads us to a final OECD initiative.

f. The OECD's "Tax Inspectors Without Borders" (TIWB) Initiative

The OECD's TIWB is a new project which **deploys tax audit experts to work directly under the management and supervision of local officials in developing country tax administrations on audits, with a particular emphasis on international tax matters**, including those covered in the Action Plan. TIWB can assist with improving the quality and consistency of tax audits, achieving sustained improvements in tax audit skills, and a resulting rise in the level of voluntary compliance by taxpayers who see a strengthening of tax administrations' ability to carry out their mandate. The project was in a pilot phase in 2014, with requests for experts from Albania, Ghana, Malawi, Papua New Guinea, Senegal and Vietnam currently being met by France, India, Italy, the Netherlands, South Africa and the United Kingdom. Progress is currently being reviewed and subject to the outcome, TIWB will be developed further and launched in 2015.

If TIWB is effective, developing countries may develop a much higher need for information on tax matters in the future.

g. EU Council Directive 2011/16/EU

The EU has introduced a Council Directive 2011/16/EU that obliges the member states to exchange information on tax matters on request and spontaneously and also to exchange specific information automatically. The information to be exchanged automatically covers a much wider range than the OECD Multilateral Competent Authority Agreement on Automatic Exchange of Financial Account Information. It also comprises information on income from employment, director's fees, life insurance products not covered by other Union legal instruments on exchange of information and other similar measures, pensions, ownership of and income from immovable property.

The obligation to provide information spontaneously regards any information available to the tax administration of a member state that causes that administration to suspect any form of tax avoidance or tax evasion in another member country. In article 9 of the Directive, various situations where this should be the case are described in more detail.



h. AMATM

ATAF has developed the ATAF Agreement on Mutual Assistance in Tax Matters (AMATM). This multilateral instrument allows for the **exchange of information, sharing of expertise, joint audits and investigations, and mutual administrative assistance among African countries**. The AMATM has the potential to be a **key instrument in the fight against BEPS in Africa**.